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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1929.

No. 90

FRANK L. SMITH, CICERO J. LINDLY, HAL W. TROVILLION, P. H. MOYNIHAN, WILLIAM BURKHARDT, EDWARD H. WRIGHT and WILLIAM J. SMITH, the persons constituting the Illinois Commerce Commission of the State of Illinois, and OSCAR E. CARLSTROM, Attorney General of the State of Illinois,

AND

Appellants,

CITY OF CHICAGO, a Municipal Corporation,

Appellant,

vs.

ILLINOIS BELL TELEPHONE COMPANY,

Appellee.

APPEAL FROM DISTRICT COURT OF THE UNITED STATES, FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION (3746).

BRIEF AND ARGUMENT FOR APPELLANTS.

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BARNARD & MILLER PRINT, CHICAGO

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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1929.

No. 845

FRANK L. SMITH, CICERO J. LINDLY, HAL W. TROVILLION, P. H. MOYNIHAN, WILLIAM BURKHARDT, EDWARD H. WRIGHT and WILLIAM J. SMITH, the persons constituting the Illinois Commerce Commission of the State of Illinois, and OSCAR E. CARLSTROM, Attorney General of the State of Illinois,

AND

Appellants,

CITY OF CHICAGO, a Municipal Corporation,

Appellant,

vs.

ILLINOIS BELL TELEPHONE COMPANY,

Appellee.

APPEAL FROM DISTRICT COURT OF THE UNITED STATES, FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION (3746).

BRIEF AND ARGUMENT FOR APPELLANTS.

EXPLANATION OF TERMS.

American Bell	American Bell Telephone Company.
American Company . .	American Telephone & Telegraph Company.
Appendix	Note: The Appendix is printed in a separate volume.
A. T. & T.	American Telephone & Telegraph Company.
Central Union	Central Union Telephone Company.
Chicago Company . . .	Chicago Telephone Company to 1921, and Illinois Bell Telephone Company since 1921.
Houston Case	*Houston* v. *Southwestern Bell Tel. Co.*, 259 U. S. 318.
Missouri Case	*State of Missouri ex rel. Southwestern Bell Tel. Co.* v. *Public Service Com. of Missouri*, 262 U. S. 276.
Missouri Company . . .	Southwestern Bell Tel. Co.
Peoria Rate Case . . .	*Re* City of Peoria and Receivers of The Central Union Telephone Company, P. U. R. 1918 E. 74.
R. .... Record	Note: Roman numeral following "R." (for example R. I) indicates Record Vol. I. Similarly R. I, 40—for example —indicates Record Vol. I, page 40.
Southwestern Bell . . .	Southwestern Bell Tel. Co.
Virginia Case	*Chesapeake & Potomac Tel. Co.* v. *Commonwealth of Virginia*, 147 Va. 43.
Western Electric . . .	Western Electric Company, an Illinois Corporation to 1915, and a New York Corporation since 1915.
Western Union	Western Union Telegraph Co.

BRIEF ON BEHALF OF APPELLANTS.

Opinion of Statutory Court.

The Opinion of the Statutory Court (R. I, 178) is reported in 38 Fed. (2d) 77.

Jurisdiction.

This is a direct appeal from a final decree (R. I, 199), entered on February 28, 1930, by the District Court of the United States, for the Northern District of Illinois, Eastern Division, pursuant to Section 266 of the Judicial Code, enjoining from enforcement, on grounds of confiscation, the rates for telephone service in the City of Chicago prescribed by the final Order of the Illinois Commerce Commission made August 16, 1923 (R. I, 14). This Court found jursdiction on June 2, 1930 (74 L. Ed. 651). On motion by appellants, this case was advanced and oral argument set for October 20, 1930.*

Statement of the Case.

Appellants here are the members of the Illinois Commerce Commission (hereinafter referred to as the Commission), the Attorney General of the State of Illinois,† who were the defendants in the court below, and the City of Chicago (hereinafter referred to as the City), which was permitted to intervene as a defendant (R. I, 178). Ap-

*On June 7th, 1930, the City advised Appellee's counsel that its brief would be printed and delivered to them on September 10, 1930, on which date a printed copy of this brief was delivered to each of them.

†The Commission and the Attorney General join in this brief on all matters wherein the position of the City is not in conflict with any order of the Commission.

pellee is the Illinois Bell Telephone Company (hereinafter referred to as the Chicago Company), which was complainant in the court below.

The Order of the Commission, the enforcement of which was enjoined below, was made as a result of extensive hearings in a proceeding instituted by it on September 13, 1921 (R. I, 15). All parties here appeared at these hearings. The transcript of the evidence presented and the arguments heard approximated 4500 pages, in addition to which there were some 200 exhibits filed by the Chicago Company and by the City, and voluminous reports were filed by the accounting staff of the Commission (R. I, 15).

The Commission's Order of August 16, 1923, reduced the rates for four classes of coin box telephone service in Chicago as fixed by the Public Utilities Commission (the predecessor of the present Commission) by Order of December 20, 1920 (R. IV, 1281), which is still in force (R. I, 189). This latter order fixed a certain schedule of rates for telephone service in the City of Chicago and suburban territory substantially in accord with the petition of the Chicago Telephone Company (predecessor in name of the Chicago Company). In that schedule increases in the then existing rates were authorized and in its Order the former Commission recited its contemplation of the possibility and probability of later rate adjustments due to a return to normal operating conditions and costs (R. I, 14). The citation by the present Commission in the proceeding leading up to the Order enjoined below, stated that it appeared that the excessively high operating conditions of that date had been considerably modified (R. I, 10). In its reply thereto the Chicago Company averred that its existing rates, fixed by the order of December 20, 1920, were just and reasonable (R. I, 13).

The Commission's Order of August 16, 1923, here in-

volved, was to be effective October 1, 1923 (R. I, 45). On December 21, 1923, the District Court granted the Chicago Company a temporary injunction on its bill filed September 21, 1923, upon condition that the Chicago Company would agree to refund to its subscribers the amounts paid by them in excess of the sums chargeable under the order of September 16, 1923, should the relief prayed be finally denied (R. I, 178, 179). This fund now aggregates in excess of $11,000,000, exclusive of interest (R. I, 179). Upon appeal by appellants, the temporary injunctional order was affirmed by this Court on October 19, 1925 (*Smith* v. *Illinois Bell Tel. Co.*, 269 U. S. 531). Thereafter on November 27, 1926, the Chicago Company filed a motion for a judgment on the pleadings (R. I, 171), which motion was denied by the Court on July 11, 1927 (R. I, 173). The final decree herein, incorporating by reference the Court's opinion of January 31, 1930, was entered February 28, 1930, after two months' hearings had been had on the trial of this cause commencing April 15, 1929 (R. I, 179).

The Statutory Court found that the net earnings for 1923, *after* making the $1,700,000 reduction under the rates established by the Order of August 16, 1923, were $6,740,000, yielding a net return of 5.39% (R. I, 197), which per cent return was constitutionally inadequate. Such net earnings were $460,000 more than the net earnings which the Chicago Company showed as available *for return from the same operations before* making the $1,700,000 reduction (R. I, 197). The latter showing was under the rates established by the Order of December 20, 1920, which were in force in 1923 under the temporary injunction issued by the Statutory Court and which are still in force (R. I, 189), but its operating expenses were increased $1,636,556 through charges for depreciation ex-

pense (R. I, 229, 420) and were increased by $360,000 for payments to the American Company (R. I, 197) in excess of those allowed by such Order.

The Statutory Court found that the Chicago Company was part of the Bell System which was operated with the avowed purpose of rendering a unified nationwide telephone service (R. I, 180), but it found that the Chicago Company and the American Telephone & Telegraph Company (hereinafter referred to as the American Company), the owner of 98% of its stock, and the parent of the System, operated in distinct fields (R. I, 182). It tested the adequacy of the rates of the Chicago Company on the basis of its being an independent enterprise (R. I, 183). It disregarded the binding character of an arrangement made in 1919 between the Chicago and the American Companies insofar as it covered the payment by the former to the latter of 4½% of its gross operating earnings, and allowed, as an operating expense, the amount of $1,364,000 prescribed by the Commission, which amount was $360,000 less than the amount charged by the Chicago Company (R. I, 191). It did not disregard the binding character of the arrangement embodied in the same document by which the American Company was given the free use, in perpetuity, in its own long distance service, of the Chicago local exchange plant, represented in 1923 by $57,000,000 book cost of plant and items of expense incurred in connection therewith aggregating $18,000,000 (R. I, 187). It held that the cost to the Chicago Company of such use could not affect the result of the case as measured by the number of long distance calls originating in Chicago (R. I, 185). Similarly it treated the relationship between the Chicago Company and the Western Electric (99% of whose stock was also owned by the American Company) as that of two separate enterprises, and found that the prices charged by

the Western Electric for its apparatus sold to the Chicago Company were reasonable (R. I, 194).

The Statutory Court added $10,214,298 to the Commission's rate base value to form the minimum rate base value, holding that the Commission's valuation did not give proper consideration to the element of reproduction cost new (R. I, 195) and could not be explained on any rational basis excepting that it had omitted $8,292,869 net additions for 1922 (R. I, 195). The record before the Commission was not before the Statutory Court. It held that it was contrary to equity and fair dealing for the Commission to make a finding on depreciation in valuation requiring the deduction from the rate base value of the entire amount represented by the depreciation reserve instead of the amount reflected by the per cent condition of the property (R. I, 193), and to make a finding on depreciation as operating charge by making an allowance which was $1,800,000 less than the Chicago Company charged in 1923 (R. I, 194). It used two calculations to test the adequacy of the rates, in one of which it reflected the Commission's finding on depreciation as an operating charge, and reflected its own finding on depreciation in valuation which involved a deduction from the rate base for depreciation of an amount which was $14,315,372 less than the amount held properly deductible by the Commission (R. I, 196, 197). In another calculation it reflected the Commission's finding on depreciation in valuation and the Chicago Company's charge to operating expense for depreciation.

Specification of Errors.

A specification of such of the assigned errors as appellants urge is that the Statutory Court erred:

1–6, 27, 35, 52–53, 62 (In failing to find and to give effect to the fact that the American Company was using, in its long distance service, the Chicago facilities, without paying any compensation or adequate compensation therefor;

7–14, 36, 63–64 (In failing to find and to give effect to the fact that the Chicago Company was making excessive, duplicate, and illegal payments to the American Company for alleged services, and was making no charge to the American Company for various services which the Chicago Company was rendering, the evidence of part of which latter services the Statutory Court erroneously excluded;

18–23, 26, 45, 51 (In failing to find that the American Company had reduced the Chicago Company to an agency of its own business and in holding that for rate-making purposes the Chicago Company was to be treated as an independent enterprise;

15, 33, 37, 44, 57–58 (In holding that the prices charged the Chicago Company for Western Electric apparatus were reasonable and that the plant account was not inflated;

25, 41–42 (In holding that the Commission's rate base value was confiscatory;

28–29, 34, 43, 58 (In holding that the net balance of the depreciation reserve could not legally be deducted from the rate base value or be used as evidence of depreciation in valuation and that the per cent condition of the property reflected the amount of depreciation in valuation to be deducted from the otherwise rate base value;

16–17, 38–39, 49, 60 (In failing to find that the net earnings available for return in the years under investigation, as found by the Statutory Court, were adequate;

24	(In failing to find that the depreciation expense
56	(charged by the Chicago Company was excessive:
30–32,	(In not dismissing the Chicago Company's bill for
40, 46–	(want of equity and in not ordering the refund of
47, 55,	(the charges collected in excess of those prescribed
59	(by the Order of August 16, 1923.

ARGUMENT.

Preliminary Statement.

The argument is divided into three parts. Part I deals with those items of revenue, expenses, and valuation which involve a consideration of the relationship between the Chicago Company, the American Company, and the Western Electric. Part II deals with those items of revenue, expenses, and valuation which involve a consideration of the basis upon which the Statutory Court handled the findings of the Commission with respect to each of the items, treating the Chicago Company as an independent enterprise apart from any relationship with the American Company other than the ownership of stock, which (as is assumed) is exercised in a bona fide way by the American Company. Part III deals with Rate of Return, treating the Chicago Company, first, as an independent enterprise and, second, as a department of the American Company.

PART I.

In the Section on Domination and Control (*infra*, 251), the argument shows that the fundamental error of the treatment by the Statutory Court of the relationship between the Chicago Company, the American Company, and the Western Electric lies in its failure to look at the entire picture of the Bell System operations as it functions in fact. The Statutory Court found that the Bell System operates to give a unified nation-wide service, in which plan the American Company, the Western Electric, and the Chicago Company each has distinct functions in distinct

fields. The Statutory Court failed to recognize and to give effect to those facts in the record which show the necessary, fundamental and functional requirement of such a unified nation-wide service. Such requirement is that the American Company control, and it in fact does control, the property and the services of the Chicago Company, and of the Western Electric without limitation of their property ownership and without limitation in the administration of their affairs arising from legal restraints incident to the separate and distinct corporate existence of each of the companies. As a result the Chicago Company and the Western Electric have both been reduced to departments of the American Company—the Chicago Company functioning in its field as an Operating Department for rendering local service, the Western Electric functioning in its field as the Manufacturing Department—to supply the necessary plant items determined by the American Company for the proper functioning of this unified nation-wide telephone service. The American Company functions in its field in the double capacity of formulating and carrying out the general policy necessary for the system as a whole and also of operating the long distance lines connecting the territories of the separate licensees.

The Statutory Court refused to find that for rate-making purposes such operation of its properties had any effect on the Chicago Company as an independent enterprise. The argument shows that the effect is sufficient in itself to change the result in the case. To show the extent of the imposition on the Chicago community as a result of the distortion of the picture by the Statutory Court, the argument discusses, first, the effect on the revenues, expenses, and property of the Chicago Company as an independent enterprise resulting from this unique relationship, and then the effect on them when the Chicago Company is viewed in its true position in the Bell System. This comparison is im-

possible, however, without taking into account the contractual relations existing between the American Company, the Western Electric, and the Chicago Company between the period from 1881 to 1908, which period antedates the starting point of the program of the American Company to operate the Bell System under the co-operative plan. The necessity of going into this early period has lengthened the brief to the extent of requiring a presentation of the historical survey of the Bell System from its beginning.

On the basis that the Chicago Company is to be treated as an independent enterprise, the effect of the operation of its properties as part of the Bell System is reflected in the following items, all of which the Statutory Court erroneously failed to take into acount in its calculations and in its decision:

1. **The use, free of charge, by the American Company in its own long distance service of the Chicago local exchange plant, representing in 1923, $57,000,000 book cost of plant, and expense items incurred in connection therewith aggregating $18,000,000; and the use in the long distance service without reimbursement of the cost of operation, of the balance of the Chicago facilities of the Chicago Company.**

Under its Original License Contract of 1881 with the American Bell Telephone Company (the predecessor of the American Company), still in force, which contract was not in the standard form used in the Bell System, the Chicago Company is entitled to receive, for the use by the American Company in its long distance service of the necessary Chicago facilities of the Chicago Company, including the Chicago local exchange plant and operating personnel in connection therewith, "a reasonable and suitable division of the tolls and profits" of the long distance business trans-

acted in Chicago. The long distance tolls in Chicago in 1923 were $8,980,000; the distribution to the Chicago Company of $2,023,209 admittedly did not cover the use of the Chicago local exchange plant. The distribution was not even sufficient to cover the cost to it of making available for use in the long distance service the balance of the Chicago facilities. The basis on which the distribution was made admittedly did not and could not take into account the profits of the long distance business transacted in Chicago.

The free use, in perpetuity, of the Chicago local exchange plant was given to the American Company under an arrangement made in 1919 which modified existing contracts between the parties, and modified filed rates in force in Chicago. But the contract was not filed with the Commission nor was the latter's consent procured prior to its effective date or thereafter—all in violation of the Illinois Public Utilities Act.

As an act of management, the 1919 arrangement is void because the directors gave the grant without making a study to determine its cost to the Chicago Company and without providing machinery by which the arrangement could be modified if it turned out to be too burdensome to the Chicago local exchange subscribers. The contract embodying the arrangement was prepared by the American Company. By 1918 the allegiance of the employees of the Chicago Company had been transferred to the Bell System as a whole, and the Chicago Company was being operated as part of a group of five companies having in common, twenty-five employees and executives—all operated as one unit, of which the American Company was the responsible head. There was, therefore, no independent management in 1918 to protect the Chicago community in the 1919 arrangement.

The 1919 Arrangement is contrary to the practice of the Chicago Company covering its local toll and local exchange services in force in Chicago; is contrary to the arrangement between the Chicago Company and 293 independent connecting companies in Illinois; is contrary to the arrangement between the Chicago Company and the associated companies of the Bell System; and is contrary to the general practice in force between separate telephone companies and between separate services of the same telephone company within and without the Bell System, and has been generally disapproved by the authorities including the case of *City of Houston* v. *Southwestern Bell Tel. Co.*, 259 U. S. 318; *Chesapeake & Potomac Tel. Co. of Virginia* v. *Commonwealth of Virginia*, 147 Va. 43, 136 S. E. 575.

The Statutory Court violated the principle established by the Minnesota Rate Cases (230 U. S. 352) in giving legal sanction to the failure by the Chicago Company to separate the costs (measured on a proper basis) of use in the long distance service of the Chicago local exchange plant as part of the separation of the intrastate from interstate business. It erroneously employed as the measure of use the number of long distance calls originating in Chicago without taking into account the calls received in Chicago, the time consumed per call, and the amount of property and operating labor used by the various classes of long distance calls made under different time schedules.

The Chicago Company has never made a study to determine the cost to it of the use of such facilities by the American Company, although the Commission's Order of August 16, 1923, complained of herein, stated that an investigation should be made to determine the proper compensation to which the Chicago Company was entitled and although the issue of the validity of the arrangement was raised by

the City during the hearings on the preliminary injunction in 1923. The Chicago Company in 1929, at the final hearings, presented no data of such cost based upon any study, although its own expert engineer described the details of such a study which he admitted to be practicable.

The additional income to the Chicago revenues from the long distance service that would be necessary to offset the burden on the Chicago service imposed by the illegal inclusion, as part of its costs of operation, of the cost of the use in the long distance service of the Chicago facilities (for the use of which facilities no compensation whatsoever, or inadequate compensation, is paid by the long distance service); or the value of the property which is used, and the expenses which are incurred in the long distance service and which are not deducted from the Chicago property and expenses, but which should be deducted under the rule established in the Minnesota Rate Cases, is in either case sufficient in amount to affect the result in this case.

2. The eight special financial services rendered by the Chicago Company without charge to the American Company in 1923:

(a) The use, free of charge, of the entire operating local organization of the Chicago Company, as the local selling agency for the sale of the American Company's stock to the public and the use of the Chicago Company's facilities and of its accessibility to more than 600,000 local exchange customers for such stock selling operations in 1923;

(b) The use, free of charge, of the facilities of the Chicago Company in selling the American Company's stock to the employes of the former, and in collecting and remitting installment payments aggregating $1,500,000 in 1923;

(c) The use of the credit of the Chicago Company to liquidate $13,800,000 long past due indebtedness owing from the Central Union Telephone Company (hereinafter referred to as Central Union), to the American Company;

(d) The use of the Chicago Company's credit to permit the American Company to withdraw in cash more than the entire amount of its capital investment in the Central Union properties transferred to the Chicago Company, which capital investment prior thereto had been wiped out through losses in operation, and at the same time to permit the American Company to retain the same interest in the future earnings of such properties;

(e) The use of the credit of the Chicago Company to finance thereafter the Central Union properties conveyed to it, in lieu of the use of the credit of the American Company which theretofore for many years had been the sole credit used for that purpose;

(f) The payment to the Central Union (and through it to the American Company, the owner of 99% of its stock) of a profit of at least $3,700,000 included in the purchase price for the Central Union properties transferred to the Chicago Company, which properties had been operated at a loss for at least seven years prior thereto;

(g) The profit to the American Company through filing consolidated income tax returns and charging the Chicago Company on the basis of a separate return;

(h) The profit to the American Company derived through the method of financing the Chicago Company by investing therein only in stock yielding 8%, as compared to the method of financing the balance of the Bell System on the basis of investing therein partly in stock yielding 8% and partly in credit obligations yielding 5.88%.

3. The charge to operating expenses for 1923 of $1,724,243, representing a standard license payment made to the American Company as the contribution by the Chicago Company towards the maintenance and expense of the common services rendered by the American Company to the Bell System as a whole.

The charge was established under an arrangement made in 1919 which modified contracts which theretofore existed between the parties and which did not provide for any such payment to cover the services therein enumerated. The arrangement was put into effect without procuring the prior consent of the Commission thereto. The payment for the use of patents embodied in the Western Electric apparatus is erroneously approved without taking into account the margin in favor of the Western Electric prices to the Chicago Company for the apparatus as against the single payment made by the non-licensees to the Western Electric to cover the same apparatus and royalties. The payment is erroneously approved for the alleged right to receive financial assistance which the Chicago Company at no time during its history required nor received. The payment is erroneously approved for the service of business management, which payment is established on the basis of an arbitrary per cent of gross operating revenue. The percentage bears no relation whatsoever to the cost of rendering the service or to the measureable benefit derived therefrom; no provision is made for a standard by which its fairness in any particular case may be tested, or for any accounting of the surplus remaining over and above the actual costs and expenses thereof. The Statutory Court erroneously disregarded the method used by the American Company to make such surplus available to the Chicago Company, as part of the Bell System.

4. The use of the Western Electric prices paid for a large portion of the entire Chicago plant as the fair cost thereof for purposes of valuation.

No showing was made—(a) that the Western Electric prices reflected the admitted large reduction in cost of production and of distribution of apparatus arising from its unique relationship to the Chicago Company as part of the Bell System, and as a purchaser of its products; (b) that the Western Electric prices reflected the part payment for such apparatus made by the Chicago Company to the American Company as part of its payment of $1,724,243 to cover royalties for patents and for improvements embodied in Western Electric patented and non-patented apparatus; and (c) that either through the Western Electric prices or otherwise an offset was provided to overcome the undue burden on the Chicago Exchange rates caused by the fact that the portion of the purchase price for Western Electric apparatus paid to the American Company is charged by the Chicago Company to operating expenses instead of to the capital account.

5. The destruction of the status of the Chicago Company as an independent enterprise.

To conform the operations of the Chicago Company to the necessary fundamental and functional characteristics of a unified nation-wide telephone service, the status of the Chicago Company as an independent enterprise was changed in the following essentials:

(a) The allegiance of its employees was transferred from it to the Bell System as a whole by means of two plans—(1) an Employees' Stock Plan in force since 1914, whereby practically each employee of the Chicago Company is given a right to subscribe at any time, at prices below the

market, for American Company stock—the administration of which plan is under the direction of the American Company. About one-half of all employees of the Chicago Company were subscribers in 1923 to such stock; and (2) an Employees' Benefit Plan, in force since 1912, whereby each employee of the Chicago Company can aspire to work anywhere in the Bell System, and any of the companies therein can obtain any employee of the Chicago Company without prejudice to his welfare and with uninterrupted benefits to him.

(b) By 1919 the Chicago Company was relieved of the obligation of maintaining anything but an operating organization.

(c) Since 1912 the Chicago Company has functioned as part of the Bell System upon the basis that "all lines of responsibility and suggestion will go up from the local representatives to the central administration (of the American Company), all lines of authority down from the central administration to the local chief."

(d) The capital and credit of the Chicago Company are pooled with that of the other subsidiaries to form a single pool of capital for the Bell System as a whole. Under this pooling arrangement the financially weak subsidiaries receive financial assistance through loans from the American Company at rates of interest below the open market rates and below its own cost of acquiring capital. The losses to it caused thereby are absorbed as part of the common costs of central administration borne by all the subsidiaries, including the Chicago Company. The Chicago Company itself has at no time during its history required or received any such assistance from the American Company. The financial assistance by the American Company to the balance of the Bell System has absorbed in many cases the entire amount, and in other cases the largest

portion, of the entire contribution made by the borrowing subsidiary to maintain the common administration—the contribution by the Chicago Company in 1923 being $1,724,243 (*supra*, 17).

(e) Through the program of standardization of equipment, which is intricate in nature, the American Company has made it impossible for the Chicago Company to purchase such equipment elsewhere than from the Western Electric But the relationship between the Chicago Company and the Western Electric was made dependent by contract on the continued licensee relationship between the Chicago Company and the American Company. Since 1919 such licensee relationship has been made by contract subject to forfeiture through voluntary assignment by the Chicago Company or by operation of law and subject to termination by the simple act of the American Company in assigning its obligation to any assignee whatsoever and in transferring the title to the telephone instruments rented from it by the Chicago Company.

These steps, taken to conform the operations of the Chicago Company to the program of the Bell System to render the unified nationwide telephone service which the Statutory Court found was accomplished by 1923, had the following effects, for rate making purposes, on the status of the Chicago Company as an independent enterprise:

(a) The possibility of operating the Chicago Company as an independent enterprise has been destroyed. It has no going value. The Statutory Court included in its rate base $4,250,000 for going value;

(b) The American Company operates the property of the Chicago Company without limitation of separate property ownership and of legal restraints in the administration of its affairs incident to the separate and distinct corporate existence of the Chicago Company. Therefore—(1)

the possibility of determining the actual costs and charges of the services of the Chicago Company from its records alone has been destroyed; and (2) part of the earnings available for return on the investment of the Chicago Company is held in the treasury of the American Company, the record of the amount of which, and the use whereof, are not available to the Chicago Company as an independent enterprise.

There is, then, no way by which the Statutory Court can determine from the record whether the net earnings which it found available for return in 1923 are all of the net earnings from such operations, and whether the net earnings which it found available, plus those in the treasury of the American Company which are not in the record, are together less than those to which the Chicago Company, as an independent enterprise, is constitutionally entitled. The Statutory Court should have dismissed the bill.

PART II.

The Statutory Court erroneously increased the valuation of the Commission by holding that the Commission's valuation was confiscatory in that it did not give sufficient consideration to the element of reproduction cost new, although the Commission's valuation represented 85.9% of its own finding on reproduction cost new and was 29% above the book cost. The Statutory Court erroneously held that the Commission did not include in its valuation as of December 31, 1922, the net additions for 1922, aggregating $8,292,869; the record before the Commission was not before the Statutory Court; the Statutory Court's conclusion was based on assumptions that are not true in fact: (a) that the price levels of December 31, 1921, did not decline during 1922; (b) that the price levels of December 31, 1922, did not decline to June 30, 1923; and (c) that the Commission was

legally bound to accept as its full face value the Chicago Company's estimate of reproduction cost new of the Chicago plant as of December 31, 1922, and as of June 30, 1923, as the sole basis for the Commission's finding of reproduction cost new of the same plant as of the same dates.

In its calculation which gave effect to the Commission's allowance for depreciation expense, the Statutory Court erroneously reduced the otherwise minimum rate base value on account of depreciation by an amount which reflected only the per cent condition of the property and which was $14,315,372 less than the net balance in the depreciation reserve which the Commission found should be deducted. In its calculation which gave effect to the full amount of deduction from the minimum rate base on account of depreciation as found by the Commission, the Statutory Court included in operating expenses an amount to cover depreciation expense which was $1,800,000 less than the allowance for the same expense as found by the Commission. The Statutory Court erroneously held that it was inequitable and unfair for the Commission to make a finding requiring that the net balance in the depreciation reserve should be deducted and to make a finding of a proper allowance for depreciation as an operating charge. This error arose from the Statutory Court's failure to grasp the functions of a depreciation reserve, the manner in which it is established and the effect of the use by the Chicago Company of the straight line method of determining depreciation expenses to provide reimbursement for property consumption which has taken place and will take place during the service life of the plant.

PART III.

The net earnings available for return in 1923-1925, as found by the Statutory Court, after making the reduction of the rates prescribed by the Order of August 16, 1923, were adequate on the basis of any one of four separate tests:

Test I. The net earnings from the Chicago operations for the years 1923 to 1925, as found by the Statutory Court, after giving effect to the reduction under the rates prescribed by the order complained of, exceeded the net earnings which the Chicago Company's books showed that it was receiving from its Chicago operations and from its entire operations during each of the years, before making such reductions. Upon the basis of its book showing the Chicago Company has attracted capital during these years on a most favorable basis and has made the stability of its securities compare favorably with those of other high grade utilities.

exceeded the yield

Test II. After adjusting the rate base value for 1923, as found by the Statutory Court to give effect to the Commission's finding on rate base value and on depreciation in valuation, the net earnings available for return in 1923, as found by the Statutory Court, were 6.61% and were clearly adequate.

Test III. The cash net earnings of 5.39% available for return in 1923, as found by the Statutory Court, are clearly adequate after taking into account the excessive payments made by the Chicago Company to the American Company and the costly services rendered, free of charge, by the Chicago Company to the American Company.

Test IV. The net earnings available for return in 1923, as found by the Statutory Court, are clearly adequate when tested on a comparable basis by the yardstick properly

applicable to determine the required minimum net earnings from the operations of the Bell licensee companies.

On the basis that legal effect is given to the finding of fact by the Statutory Court that the Chicago Company is operated as part of the Bell System with the avowed purpose of rendering a "nationwide and unified telephone service," such legal effect must take into account the following:

The American Company has made itself the financing company to provide the permanent capital for the Chicago Company and the other Bell licensees. The financing is done on a co-operative plan under which the Chicago Company and each licensee makes the following contributions: It performs within its own territory, without charge, such uniform services for the headquarters department, represented by the American Company, as the latter may require, such as selling stock, advertising the Bell System as a whole, making available personnel to other licensee companies, and making available the use in the American Company's long distance service of the Chicago local exchange plant and operating personnel in connection therewith. It pays to the headquarters department for the use of permanent capital or of temporary funds supplied by it, uniform cash dividends, or interest rates, and pays a yearly uniform assessment, determined by the American Company, to maintain the headquarters department. It pays uniform prices for all purchases made from the manufacturing department of the Bell System, represented by the Western Electric. After absorbing the costs and expenses of performing these services and of making these payments, the Chicago Company is expected to maintain net earnings from its own operations to yield a per cent return on its investment not less than the average per cent return on a comparable basis on the investment of the other licensee companies as a whole as used or found neces-

sary to attract capital and to maintain the stability of the securities of the Bell System.

The American Company, on its part, pools its own physical assets and the physical assets of all the licensee companies to form the rate base on which it calculates what will be the adequate per cent return to attract investors of the American Company, who are considered the investors of the Bell System. All of the net earnings in the treasury of the American Company, plus all of the net earnings of the licensee companies from their own operations, are pooled for the purpose of making the necessary showings to attract capital to the Bell System as a whole. All of the net earnings in the treasury of the American Company, plus the cash dividends paid by the licensee companies and by the Western Electric, are made available to pay the cash return to its own investors as the investors of the Bell System. All of the funds derived by the American Company from its own investors are used to finance every part of the Bell System. The American Company, by consenting to the pledge by a licensee company of the latter's rights under its contract defining its relationship to the Bell System, makes available to the holders of the credit securities issued by each such borrowing licensee Company, the same benefits of the co-operative financing plan as are available to the stock investors of the American Company as investors of the Bell System.

Under such a plan of co-operative financing the required net earnings from the operations of each licensee company are admittedly less than the minimum per cent return necessary to attract capital to it as an independent enterprise or to maintain the stability of its securities. There is no possible basis of comparison between the required minimum net earnings from the operations of each licensee company and those of independent enterprises to

which it might be expected to be similar. There is no possible basis on which the yardstick applied in cases of independent enterprises to determine the minimum net return to which a utility is constitutionally entitled, can be applied to determine the minimum net earnings from its own operations to which a Bell licensee company is constitutionally entitled. The only possible applicable yardstick is the average minimum per cent return on a comparable basis, on the investment of the licensee companies as a whole necessary to finance their needs and to maintain the stability of their securities. Tested by this yardstick, the net earnings from the Chicago exchange services available for return in 1923, as found by the Statutory Court, are more than the minimum which the Chicago Company is constitutionally entitled to receive therefrom, such net earnings representing a return of 6.2% of the book cost of Chicago property in service, while the average net earnings in 1923 from the operations of the Bell licensees, as a whole, represented 5.4% of the book cost of corresponding property in service (*infra,* 379).

DISCUSSION OF SPECIFIC POINTS OF BRIEF AND ERRORS OF STATUTORY COURT.

PART I.

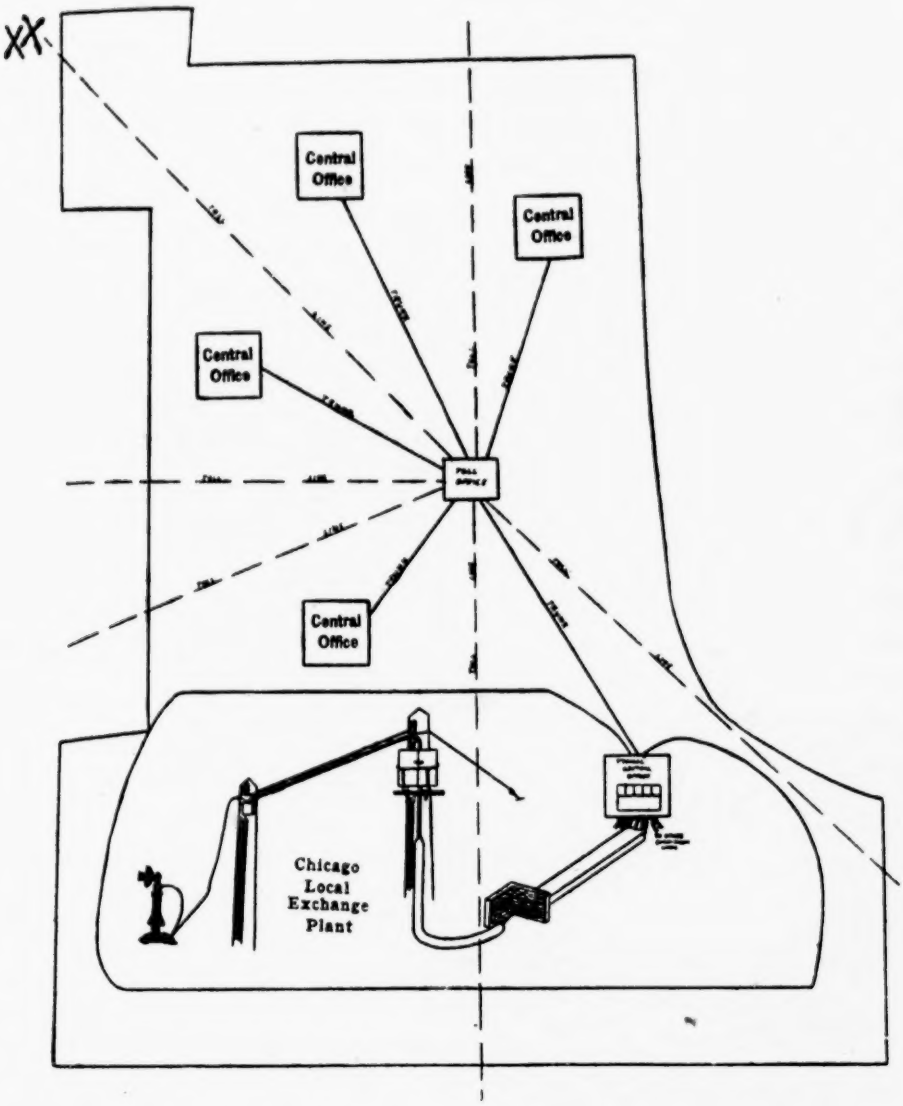
LONG DISTANCE ARRANGEMENT WITH AMERICAN COMPANY.

The American Company in 1923 used in its long distance service, free of charge, that portion of the Chicago Company's property called for convenience the Chicago local exchange plant representing a book cost of $57,000,000 and items of expenses aggregating $18,000,000; it used the balance of the Chicago Company's necessary facilities without reimbursement of the costs of operation thereof; and it withheld from the Chicago Company its share of the profits from the long distance service to which the latter was admittedly entitled under the contract between the two companies.

"Long Distance service" herein discussed is the service rendered by the American Company to persons originating or receiving at telephones of the Chicago Company in Chicago, personal communications to or from persons outside the territory of the Chicago Company over circuits composed of the lines of the two companies. The right to the continued use of the facilities of the Chicago Company in the long distance service was given to the American Company upon its "making a reasonable and suitable division of the tolls and profits" of the long distance business (R. VI, 1929), as provided in Section 10 of the Original License Contract of 1881 still in force between the two companies (*infra,* 41).

The American Company owns no property whatsoever in Chicago. There are three classes of property of the Chicago Company used in long distance service in Chicago: (1) That part of the property referred to as "Local Exchange Plant," from the subscribers' and public pay stations to the toll trunks or toll switchboard, which local exchange plant is used in the local exchange and toll services; (the local exchange plant represents 60% of the entire physical exchange property in Chicago and in 1923 represented property of a book cost of $57,000,000 (R. V, 1742); the expenses attributable to its operations in 1923 were in excess of $18,000,000); (2) the "Trunks" between seventy branch exchange offices (R. I, 225) used jointly in the toll service of the Chicago Company and the long distance service (R. V, 1740). Neither the value of the toll trunks nor the expense of their operation in 1923 is known, as to which no study or investigation has been made since 1911 (R. II, 841); and (3) the "Long Lines Plant" used exclusively in long distance service, the book cost of which in 1923 was $2,349,325 (R. VI, 1275).

These three classes of property are shown on the following chart:



The Chicago Company in 1923 received as its share $2,023,209 or 22.53% of the $8,980,000 gross tolls of long distance business transacted in Chicago (R. IV, 1571). Neither the distribution of nor the total net profits from the $8,980,000 gross tolls, nor the portion thereof retained by the American Company were shown.

The distribution of $2,023,209 to the Chicago Company was subdivided as follows:

$ 257,244—Compensation for the use of the necessary exchange facilities excepting the use of the Chicago local exchange plant and operating personnel in connection therewith (R. IV, 1571).

105,670—Compensation for the use of toll trunks (R. IV, 1571).

93,835—Compensation for the use of the long lines plant (R. IV, 1571).

231,267—Compensation for supervision of employees operating long lines plant (R. IV, 1275, 1571).

1,335,193—Expenses in operating and maintaining long lines plant (R. IV, 1275, 1571).

$2,023,209

The Commission's Order merely passed on the amount of the payments covering the use of the exchange facilities and of the toll trunks. Although it disapproved, it included these payments in its estimated revenues under the rates complained of, because "there are not sufficient facts in this record to permit of making a proper adjustment" (R. I, 39). The Statutory Court passed on and approved the entire distribution to the Chicago Company (R. I, 187).

ERROR OF STATUTORY COURT.

The City contends that the Statutory Court erred because:

(I) The distribution to the Chicago Company admittedly was not intended to and in fact did not allow any reimbursement or compensation whatever to the Chicago Company and to the Chicago Exchange for the use in long distance service of its Chicago Local Exchange Plant and its operating personnel in connection therewith;

(II) The distribution did not even reimburse the Chi-

cago Company for the cost of making available to long distance service the necessary facilities in Chicago other than its local exchange plant and operating personnel in connection therewith;

(III) The basis on which the distribution was made admittedly did not and could not take into account the *profits* of the long distance business transacted in Chicago; and

(IV) The failure of the Chicago Company to show that it had received a "reasonable and suitable division of the tolls and profits" of the long distance business transacted in Chicago has destroyed the possibility of determining the legal inadequacy of the Chicago Exchange rates.

SUMMARY STATEMENT OF CITY'S CONTENTIONS.

In support of its contention numbered (1), the City offers the following:

A. The Chicago local exchange plant, represented in 1923 by $57,000,000 book cost of property, and by items of expense attributable to its operations aggregating at least $18,000,000, was part of the necessary facilities of the Chicago Company in fact used in the long distance service of the American Company.

B. The payment to the Chicago Company of $2,023,209 was not intended to, and did not, leave any margin available to compensate the Chicago Company for the use in the long distance service of the local exchange plant and operating personnel in connection therewith.

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*The American Bell Telephone Company (hereafter referred to as the American Bell) was the Licensor of the Chicago Company and the parent holding company from 1881 to 1899 (*infra*, 40, 170). Thereafter the American Company, which was organized as the licensee of the American Bell, to operate the long distance service (*infra*, 42), succeeded to the business and contracts of the American Bell and became the parent of the Bell System (*infra*, 170). The title "American Company," as used in the text, is intended to cover the company which for the time being was the *parent* of the Bell System, unless for special reasons the American Bell is named.

C. The 1919 Arrangement which gave the use in the long distance service of the Chicago Local Exchange Plant and operating personnel in connection therewith free of charge or cost to the American Company modified:

(1) existing contracts between the American and Chicago Companies; and,

(2) filed rate schedules in force in Chicago.

D. The 1919 Arrangement was void because:

(1) the compliance with the procedural requirements of the Public Utilities Act of Illinois necessary as a condition precedent to making the 1919 Arrangement legally effective was not made;

(2) the 1919 Arrangement violates Statutory Substantive Law;

(3) the 1919 Arrangement is not such an act of management as should be sanctioned;

(4) the 1919 Arrangement is contrary to the practice of the Chicago Company covering its local toll and exchange rates in force in Chicago;

(5) the 1919 Arrangement is contrary to the arrangement between the Chicago Company and 293 independent connecting companies in Illinois;

(6) the 1919 Arrangement is contrary to the arrangement between the Chicago Company and the Associated Companies of the Bell System;

(7) the 1919 Arrangement is contrary to the general practice in force between separate telephone companies and between separate services of the same telephone company within and without the Bell System and has been generally disapproved by the authorities;

(8) The sanction by the Statutory Court of the failure by the Chicago Company to separate from the costs of the Chicago Exchange service the costs (measured on a proper basis) of use in the long distance service of the Chicago local exchange plant and operating personnel in connection therewith is contrary to law.

In support of its contention numbered (II), the City offers the following:

A. The compensation for the use of the balance of the necessary exchange facilities, excepting the use of the local exchange plant and operating personnel in connection therewith, and for the use of the toll trunks, is arbitrary and grossly inadequate.

B. The return to the Chicago Company on its investment in long lines plant is 40% lower than the return which it considered a fair return on the investment of property leased by it from the American Company.

C. In addition to receiving no compensation for the use in the long distance service of its local exchange plant and operating personnel in connection therewith, the Chicago Company receives no compensation for the use of other necessary facilities made available to that service.

In support of its contention numbered (III), the City offers the following:

A. The method of settlement in the long distance service does not take into account the three special factors for which the Chicago Company is entitled to compensation from the profits of the long distance business.

B. The method of settlement with the Chicago Company destroys the benefit to it of Section 10 of the Original License Contract of 1881 and revokes the long distance arrangement between the parties.

In support of its contention numbered (IV), the City offers the following:

A. There is no possible standard by which the fairness of the distribution can be determined from the facts appearing in the record.

B. The additional net income to the Chicago revenues from the long distance service necessary to offset the burden on the Chicago service imposed by the illegal inclusion, as part of its costs of operation, of the cost of the use in the long distance service of the Chicago facilities, and for the use of which facilities no compensation whatever, or inadequate compensation, is paid by the long distance service; or the value of property which is used, and the expenses which are incurred in the long distance service and not deducted from the Chicago property and expenses, but which should be deducted under the rule established in the Minnesota Rate Cases, is in either case sufficient in amount to affect the result in this case.

DISCUSSION AS TO CONTENTION NUMBERED I.

I.

THE DISTRIBUTION TO THE CHICAGO COMPANY ADMITTEDLY WAS NOT INTENDED TO AND IN FACT DID NOT ALLOW ANY REIMBURSEMENT OR COMPENSATION WHATEVER TO THE CHICAGO COMPANY AND TO THE CHICAGO EXCHANGE FOR THE USE IN LONG DISTANCE SERVICE OF ITS CHICAGO LOCAL EXCHANGE PLANT AND ITS OPERATING PERSONNEL IN CONNECTION THEREWITH.

A.

The Chicago Local Exchange Plant, represented in 1923 by $57,000,000 book cost of property, and by items of expense attributable to its operations aggregating at least $18,000,000, was part of the necessary facilities of the Chicago Company in fact used in the long distance service of the American Company.

Telephone Service Unique.

Service rendered to a telephone user differs functionally and fundamentally from services rendered by any other form of public utility. The Telephone Company does not transport persons or goods or messages, but places at the disposition of any customer a telephone circuit consisting of two wires, connecting such subscriber with another person at a distant point, thereby enabling them to do the communicating. The Telephone Company leases its circuits to others for their exclusive service for the time being (R. VII, 2463 (38); R. VII, 2465 [42, 43].

DEFINITIONS.

A "telephone instrument" consists of transmitter, receiver and induction coil. A "telephone station" is what is commonly spoken of as a "telephone", and embraces, among other things, the telephone instrument itself, plus the associated equipment—such as the bell, wire connections, etc.,—necessary for personal conversation over the telephone instrument (*Telephone Cases*, 126 U. S. 1; *Re New England Tel. & Tel. Co.* (Maine), P. U. R. 1926B, 247, 286).

> "• • • an 'exchange' or a 'district or exchange system' applies to a system in which different stations on the same or different circuits, and either within any city or town, or within a radius of fifteen miles of a central office • • • are connected with such central office or branch offices within said territory for the purpose of placing subscribers or other parties by such circuits in communication with such central or branch offices, or with each other, either directly or through the agents of the system" (R. VI, 1904; R. IV, 1197).

Telephone connection between persons in separate exchange systems is known as "Extra-territorial Connecting Service", and may be between exchange systems of the same company or between exchange systems of separate companies. Connection between exchange systems of one company over the extra-territorial wires of the same company is known as "Local Toll Service." Where the wires connecting exchange systems of separate telephone companies are owned by both or either of such companies, the service is known as "Connecting Company Service." This latter service is known as "Connecting Line Toll Service," if the wires connecting the different exchange systems are owned by a third company. The "Long Distance Service" herein discussed is "connecting line toll service" where the American Company owns the wires connecting the different exchange systems within or without the Bell System.

NATURE OF LONG DISTANCE SERVICE.

Parties have the exclusive use of circuits for long distance communication while the connections between the two persons who are to talk are being made, and, of course, while they are actually conversing. During this interval, no part of any one of the circuits making up the combination of circuits, nor the telephone instruments of the speaker or the listener, can be used for any other telephone service (R. VII, 2464 (42)). During a long distance communication between a person in Chicago and one in New York, each and every part of the equipment of the Chicago Company, beginning with the telephone instrument of the speaker, necessary to form (together with wires and equipment of companies beyond its territory) the circuits, is held by the Chicago Company exclusively for that speaker during the interval of his long distance communication, as is likewise every other part of such circuits. There is no conceivable difference between the use of the property of the Chicago Company necessary for such long distance communication and that of the American Company, during the time interval of the long distance communication* (R. VII, 2524 (43); *Southern Bell Tel. & Tel. Co.* v. *R. R. Com. of Georgia*, 274 Fed. 438, Certiorari denied, 262 U. S. 761.

The customers of the American Company using the telephone stations in Chicago to originate or to receive long distance messages might or might not be, or they might or might not theretofore have been, or they might or might not thereafter ever become, customers of any of the services of the Chicago Company.

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*To make the analogy of a long distance call and travel over a railroad comparable, we must assume that the owner of a private car in Chicago leases the starting apparatus, the entire track from Chicago to New York, the terminal facilities necessary to the operation of the entire track, plus the apparatus necessary to stop the car in New York—all for his exclusive use during the entire period when the private car travels to New York and back to the starting point in Chicago.

CONTROL OVER LONG DISTANCE RATES.

The American Company alone establishes and controls long distance rates (R. II, 834). The Chicago Company has the *privilege* of offering the long distance service to its own customers at the established rates. The Illinois Commerce Commission has no jurisdiction over long distance rates; no schedules are filed with it; nor need they be filed with the Interstate Commerce Commission (*Western Union Tel. Co.* v. *Esteve Bros. & Co.*, 256 U. S. 566); nor are they, nor is the basis upon which they are established, in the record.

B.

The payment to the Chicago Company of $2,023,209 was not intended to, and did not, leave any margin available to compensate the Chicago Company for the use in the long distance service of the local exchange plant and operating personnel in connection therewith.

The distribution in 1923 was made in conformity with an arrangement made effective in 1919 pursuant to contract (R. IV, 1196). By this contract the Chicago Company agreed in perpetuity (a) to make no charge whatever to the American Company and/or to those of the latter's customers who were not also customers of the Chicago Company's local exchange service for making use of its local exchange plant and its operating personnel in connection therewith, in originating or receiving long distance communications; (b) to make no charge whatever to the American Company and no separate and specific charge to the American Company's customers who were at the same time local exchange customers of the Chicago Company for making use of its local exchange plant and operating personnel in connection therewith, in originating or receiving long distance commu-

nications; (c) to establish the entire cost and expense of such use of the local exchange plant and operating personnel in connection therewith, and the return on the entire investment thereon, as a general burden to be assumed and to be paid only by all users of and all subscribers to the local exchange service of the Chicago Company, whether or not they, in fact, used or whether or not they desired to use, the long distance service of the American Company (R. IV, 1204). This contract, in effect in 1923, was executed and was made effective without procuring the consent and approval of the Public Utilities Commission of Illinois and was not filed with it before or after its effective date (R. V, 1785).

The distribution of $2,023,209 to the Chicago Company to cover the use in the long distance service of the balance of the Chicago facilities other than the use of the local exchange plant and operating personnel in connection therewith was not sufficient to cover the cost of use of such excepted facilities (*infra*, 117).

C (1)

The 1919 arrangement which gave the use in the long distance service of the Chicago local exchange plant and operating personnel in connection therewith free of charge or cost to the American Company modified existing contracts between the two companies.

1. Western Union Contract of 1879.

Prior to 1879 the National Bell and the Western Union held rival telephone patents. Both companies operated, directly and through licensees, telephone exchanges in over seventy-five cities in the United States (R. VI, 1913-1917); they were also contesting the priority of their patents. In 1879 the controversy was settled by a contract (R.

VI, 1887)—referred to herein as the "Western Union Contract"—which contract is the key to the entire history of the Bell System. This contract became the subject-matter of continuous litigation from 1884 to 1913 between these parties (*Western Union Tel. Co.* v. *American Bell Tel. Co.*, 105 Fed. 684 (1900); 125 Fed. 342 (1903); 187 Fed. 425 (1911); 203 Fed. 785 (1913); certiorari denied 231 U. S. 753; the construction placed thereon by them and by the courts forms the starting point for the discussion herein.

Under the Western Union contract concerning long distance service, the National Bell had the exclusive right, by Article 12, to all uses of the telephone instruments in exchange systems, subject to the rights of Western Union licensees and of the Western Union for its own purposes (Exchange Service) (R. VI, 1904); by Article 13, "to connect district or exchange systems for the purpose of personal conversation between persons at the instrument and the right to use telephones on all lines not forming a part of a telephonic district or exchange system for such personal conversation" (Extra-territorial Connecting Service) (R. VI, 1904).

2. Chicago Company's Original License Contract of 1881.

In 1881 the American Bell, successor to the National Bell, and the Western Union licensee operating in Chicago (*Western Union Tel. Co.* v. *American Bell Tel. Co.*, 187 Fed. 425, 464), joined to transfer their business to the Chicago Company to be organized and operated under an American Bell license contract issued in the same year (R. VI, 1925).

By this contract differing materially from the standard form (*infra*, 85) the Chicago Company was granted a perpetual exclusive license to use the telephone to do a telephone business in seven counties in Illinois and in two counties in Indiana (Sec. 2) (R. VI, 1925, 1926) for "all pur-

poses for which the Licensor has or shall have the right to use" the same under the Western Union Contract, i. e., for exchange, local toll service and connecting company service. The rent and royalty to the American Bell for the use of the telephone was 50% of the rental charge made by the Chicago Company to its customers for the use of the telephone (Sec. 9) (R. VI, 1928). The American Company received no additional compensation from the local toll or connecting company services.

Section 10 provided:

> "In case the Licensor, its successors, or grantees shall desire to connect points within said territory, with points outside said territory, they shall have the right to connect with or avail themselves of the lines and facilities of the party of the second part (Chicago Company) or its licensees, owners of exchanges or public lines making a reasonable and suitable division of the tolls and profits of such extra-territorial and through business; and if or so far as said licensee or its sub-licensees shall not have or shall not furnish suitable lines and facilities, then said American Bell Telephone Company may within said territory construct such lines and use such telephones as may be necessary for such purposes." (Connecting Line Toll Service and Long Distance Service; R. VI, 1929).

The clause "points within said territory" conceivably might mean either exchange offices or exchange stations. However, Section 10 obviously reserved to the American Bell the right which was given to it under Article 13, Section 1, of the Western Union Contract (*supra*, 39), i. e., "the right to connect telephonic district or exchange systems for the purpose of personal conversation between persons *at the instruments*" and the right "to use *telephones* on all lines not forming a part of a telephonic district or exchange system for such personal conversation" (R. VI, 1904). A construction of Section 10 which obligates the Chicago Company to connect its *central offices* as the

"points," but carries no obligation to keep connected the *stations to the central offices* during the period of the long distance communications, would render illusory the right reserved to the American Bell. "Points within said territory" includes exchange stations.

3. American Company Long Distance Contract of 1894.

In 1886 the American Bell organized the American Company for the purpose of rendering telephone service between exchange systems of different companies known as "Long Distance" Service. The American Company received a temporary license, which in 1894 was made perpetual (R. VI, 1990), and which required it to assume the obligation to pay—(a) the exchange licensees the portion of the toll charges required by their respective license contracts to be paid for the use in extra-territorial connection service of exchange facilities (R. VI, 1996); and (b) the American Bell 15% of the gross toll charges (R. VI, 1997). For these payments the American Company was given the right to

> "construct lines and may use such lines for telephonic personal communication between a customer in the territory of one such licensee and a customer in the territory of another such licensee. * * * For the purpose of establishing telephonic personal communication between customers as aforesaid, the lessee may have and exercise all the right to construct and operate telephone lines and maintain suitable offices and connect with exchange systems (defined *supra*, ...) established or to be established as aforesaid, which the Lessor has reserved and is or may be entitled to grant for extra-territorial connecting lines under licenses to exchanges made or to be made as aforesaid; but the Lessee shall connect with each local exchange and do its business so far as the same can conveniently be so done, with the customers thereof through said exchange * * *" (R. VI, 1993).

It is obvious that the long distance telephone service contemplated by this license was to be given to persons *at exchange stations* and not at exchange offices.*

4. Chicago Company's Long Distance Contracts Covering the Use of Exchange Facilities.

(a) 1891 Contract.

By 1891 the American Company had extended its lines to Chicago (R. V, 1739) and the Chicago Company had for ten years operated its local exchange, local toll and connecting company services. From its very profitable business the Chicago Company paid cash dividends ranging from 30% to 51%, averaging over 40% a year for the entire period, on a capitalization ranging from $500,000 to $2,000,000 (R. V, 1859, 1860). Then serving a million people in Chicago alone, with over 6,600 telephones in service (R. VI, 2299), its entire business was done over what was known as a "grounded magneto line," not practically adaptable for long distance service as developed by the American Company (*Chicago Tel. Co.* v. *Ill. Mfg. Assn.*, 106 Ill. App. 54). From the beginning, long distance service has been established on metallic circuits (R. V, 1739).

In 1891 the American and Chicago Companies entered into a contract (R. VI, 1934) declared to be a temporary modification of some of the provisions of and "to provide more explicitly for certain details of operation" of the license contracts held by both companies, but "was not to violate any provision thereof." It was to continue for a minimum period of one year and until terminated by thirty days' notice by either party.

*The long distance rates cover connections between stations (R. VI, 2319).

The Chicago Company agreed:

1. To build, equip, and maintain, and to make available for long distance service (a) special terminal loops from its several local exchange offices "to such points within the districts of the various exchanges as the American Company may from time to time direct"; (b) a sufficient number of public pay stations to meet the reasonable needs of the public for long distance service; and (c) its subscribers' stations.

2. To bill, collect, and settle the account in each case.

The American Company agreed to pay the Chicago Company, for all of these services, a specific sum per month for each terminal loop, plus 30% of the cash receipts from business originating at public pay stations, not to exceed 20¢ per connection, and 15% of the cash receipts from business originating at subscribers' stations, not to exceed 10¢ per connection. This basis of compensation was predicated on (a) the American Company's paying the labor cost of the operators at the exchange offices to switch the local lines on to the long distance line or toll board, and (b) the American Company's paying to the Chicago Company reimbursement of the actual expense of operation, plus 10% thereof, should the Chicago Company be required to operate property owned by the American Company.

Observe that (1) the compensation to the Chicago Company was for the use of all of its necessary facilities, in fact used in the long distance service from and including the exchange stations to the toll board or toll trunks, and not merely for billing, collecting, and settling the charges; (2) the compensation was subject to modification from time to time by request of either party according to the standard prescribed by Section 10 of the Original License Contract of 1881.

(b) 1896 MODIFICATION.

In 1896 the basis of compensation prescribed in the 1891 Contract was changed to an "arbitrary terminal commission of 12¢ per paid long distance message" originating at all stations of the Chicago Company. The change was made to avoid the complication and expense of figuring the commission on each message and was to be modified "from time to time as an investigation of the account disclosed that this payment should be increased or diminished." (R. VI, 1938).

(c) 1899 MODIFICATION.

In 1899 a study was made of six months' commissions to the Chicago Company for long distance messages from all stations on the basis of compensation prescribed in the 1891 Contract. The average payment being $.1198 per connection, the parties adopted 12¢ per message (paid or free) originating at all stations of the Chicago Company as the basis of settlement, "subject to revision upon request of either party" (R. VI, 1940, 1941). This compensation was therefore an elastic basis of computation, varying with the changes in the bases under the 1891 arrangement which, as we have already seen, are themselves subject to readjustment according to standards prescribed in Section 10 of the Original License Contract of 1881.

(d) 1917 MODIFICATION.

In 1917, "in view of the extraordinary conditions due to the state of war," the basis of compensation provided for in the 1891 Contract for subscriber station business was changed from 15%, not to exceed 10¢, to 25%, not to exceed 12¢, per originating message, and for public pay station business from 30%, not to exceed 20¢, to

50%, not to exceed 24¢ per originating messages (R. VI, 1972). The 1917 Modification was not made applicable to Chicago, "as to which special conditions obtain" (R. VI, 1973). Certainly in 1917 the cost of billing, collecting, and settling the toll accounts *in Chicago* was not less than the cost in the balance of the territory of the Chicago Company. Nor is there one iota of evidence in the record of any *special conditions in Chicago* as to billing, collecting, and settling the long distance accounts.* Therefore the mere fact that Chicago commissions were not increased in 1917 is conclusive proof that the rates of commission prescribed in the 1891 Contract did not *cover merely the billing, collecting, and settling of accounts* but also the use in the long distance service of the necessary facilities used in the long distance service (including the use of the local exchange plant and operating personnel in connection therewith), about all of which use there was a special arrangement in Chicago. No other change was made to 1919 in the arrangement covering the use in long distance service of necessary exchange facilities.

5. TOLL TRUNK ARRANGEMENT.

As the Chicago Exchange grew, it developed branch exchange offices from which special trunks were built direct to the toll switchboard for long distance service, and other special trunks for local toll and extraterritorial connecting service. For the use of these trunks in the long distance service, the American Company, prior to 1911, paid a flat

* It is not sufficient to point out that in Chicago the switching and operating were done by the American Company, inasmuch as the rates of commission prescribed in the 1891 contract were predicated upon the switching and operating being done by the American Company (R. VI, 1935, *supra*, 44). Where the Chicago Company did switching (outside of Chicago) the compensation to it was prescribed as a percentage of the toll, which was added to the normal percentage prescribed in the 1891 Contract for the use of the local exchange plant plus billing, collecting, and reporting the charges (R. VI, 1942). The 1917 Modification also increased the basis of compensation for switching established in 1909.

annual rental (R. V, 1740). In that year, the two companies agreed to use the same trunks. As the annual rental paid by the American Company prior thereto averaged 5¢ per paid originating long distance message, the parties adopted 5¢ per paid originating message as the compensation to the Chicago Company for the use in the long distance service of the toll trunks (R. VI, 1943). No further study nor change in arrangement was made to 1919 or thereafter.

6. LONG LINES PLANT ARRANGEMENT.

Prior to 1911 the American Company had built up, owned, and operated its own long lines plant in Chicago for its long distance service. Between 1911 and 1913 the Chicago Company purchased that plant and took over its operating employees (R. VI, 1944). The Chicago Company then agreed (a) to lease to the American Company that plant, plus the necessary additions thereto, which it agreed to provide from time to time (all referred to herein as the long lines plant, *supra*, 28); and (b) to operate the long lines plant under rules prescribed by the American Company. As compensation therefor, the American Company agreed to pay the actual monthly expenses, plus 10%; and, as rental, to pay the maintenance, taxes and depreciation calculated on a fixed percentage basis of book cost of plant, plus 10% of the average monthly book cost of plant. No period of duration for the arrangement was specified; the arrangement was declared to be in lieu of the "reasonable and suitable division of the tolls and profits" of the long distance business in Chicago, insofar as the division was to compensate for the use and operation of the long lines plant (R. VI, 1946). No change in this arrangement was made to 1919 or thereafter.

SUMMARY.

To sum up the contractual relations in 1918:

The Original License Contract of 1881 established the standard of a "reasonable and suitable division of the tolls and profits" of all long distance business originated or received in Chicago, as compensation to the Chicago Company for the use in the American Company's long distance service of all necessary facilities of the Chicago Company in Chicago. By contract, from time to time, definite compensation was established and readjusted, according to the standard of the Original License Contract of 1881, for the use in the long distance service of the various parts of such necessary facilities, including therein the compensation for the use of the Chicago local exchange plant and its operating personnel in connection therewith.

No contract between the parties included as part of the expenses of the Chicago local exchange service the costs of the use in the long distance service by the American Company or by its customers (whether subscribers or non-subscribers of the Chicago local exchange service), of the Chicago exchange plant or operating personnel in connection therewith. Nor did any contract create a right in the American Company and/or in its customers to use, free of charge, in the long distance service, the Chicago local exchange plant and the operating personnel in connection therewith. Nor did any contract between the parties provide that the rates for local exchange service in effect in Chicago should absorb in perpetuity all or part of the cost to the Chicago Company of making available in the long distance service the balance of the necessary exchange facilities (other than the local exchange plant and operating personnel in connection therewith).

CIRCUMSTANCES OF THE MAKING OF THE SO-CALLED FEBRUARY 1919 CONTRACT OR MEMORANDUM.

Between November 27, 1918, and February 1, 1919, the Chicago Company and the American Company executed a "Memorandum" (R. IV, 1196), which was prepared by the Legal Department of the American Company (R. V, 1602). We are discussing here only those provisions relating to long distance service.

The 1919 Memorandum recites that it is "stating and reaffirming the contractual relations now and heretofore existing between the parties hereto" (R. IV, 1197).

The Memorandum did not, however, restate and reaffirm the entire long distance arrangement in Chicago between the parties:

1. It made no mention of the contractual relations regarding the use and operation of the long lines plant (*supra*, 47).

2. It made no mention of the contractual relations regarding the use of toll trunks (*supra*, 46).

It covered only the contractual relations regarding the use in the long distance service of the necessary exchange facilities, by changing (a) the basis of compensation for the use in the long distance service of the local exchange plant and operating personnel in connection therewith, and (b) the basis of compensation for the use in the same service of the balance of the exchange facilities.

(a) Local Exchange Plant and Operating Personnel—Revision.

On page 38, *supra*, are detailed the provisions of the 1919 Memorandum covering the use in the long distance

service of the local exchange plant and the operating personnel in connection therewith. By these provisions, the Memorandum established a new irrevocable arrangement whereby the Chicago Company was precluded from ever including the use in the long distance service of the local exchange plant and of the operating personnel in connection therewith as part of its necessary facilities to connect "points within its territory to points outside of its territory," for the use of which necessary facilities the Chicago Company was entitled to a "reasonable and suitable division of the tolls and profits" of the long distance business transacted in Chicago under Section 10 of the Original License Contract of 1881.

The effect of the new arrangement is to grant to the American Company the use in its long distance service of the Chicago Company's local exchange plant and operating personnel in connection therewith without payment by the American Company of any compensation therefor, to the extent that the distribution of the long distance tolls and profits to the Chicago Company leaves an insufficient margin of net profit to compensate also for such use of the local exchange plant and operating personnel in connection therewith. As the 1919 Memorandum clearly indicates an intention not to provide to the Chicago Company from the long distance business any such margin, it is clear that the effect of the 1919 Arrangement is in fact a *grant* to the *American Company* of the *free* use in its long distance service of the Chicago Company's local exchange plant and operating personnel in connection therewith.

(b) Balance of Exchange Facilities—Revision.

The Memorandum likewise established a new irrevocable arrangement whereby the basis of 15% of the originating subscriber or pay station calls, was fixed as the standard

upon which compensation was to be paid to the Chicago Company for the use in the American Company's long distance service of the balance of the necessary exchange facilities of the Chicago Company excepting the use therein of the latter's local exchange plant and operating personnel in connection therewith (R. IV, 1204). The balance of such necessary exchange facilities includes the service of billing, collecting and settling the accounts, of making available the customers of the services of the Chicago Company as potential customers for the long distance service of the American Company at subscribers' stations, and of making accessible subscribers' and public pay stations to non-customers of the Chicago Company for long distance service.

This fixed standard was established without the possibility of adjustment no matter what the cost might be to the Chicago Company of making available the balance of such necessary exchange facilities. This new arrangement covering the balance of the necessary exchange facilities replaced the arrangement embodied in Section 10 of the Original License Contract of 1881 whereby such balance of necessary exchange facilities constituted a part of all the necessary facilities of the Chicago Company, for the use of all of which it was entitled to receive "a reasonable and suitable division" of the tolls and profits of long distance business in Chicago.

This new arrangement covering the use of the balance of the necessary exchange facilities throws light on the true character of the 1919 Memorandum.

On all charges over 66¢ the 15% commission, with a maximum of 10¢ for originating subscribers' station messages, is, in fact, 10¢, with double that amount for originating public station messages. In view of the fact that the average long distance charge in Chicago in 1913 was $1.43,

and that it has increased since that date to $2.24 (*infra*, 120), it is obvious that the 15% and 30% bases of compensation were applicable to a constantly decreasing number of messages and the 10¢ and 20¢ bases to a correspondingly increasing number. The percentage basis established by the new arrangement, when applied to actual operations of the Chicago Company, are therefore illusory in nature. Indeed, settlement has at no time been on the percentage basis of the new arrangement. Settlement has been on the basis of 12¢ per message originating at subscribers' and public pay stations, although no study has ever been made to determine what the fixed per message compensation would be on the basis established in the 1919 Memorandum. Nor is there anything in the record to show the basis on which the 12¢ charge was fixed (*infra*, 117).

The fact that the 1919 Memorandum expresses the basis of compensation for use in long distance service of the necessary exchange facilities, *exclusive* of the use of the local exchange plant and operating personnel in connection therewith, in terms identical to the basis of compensation used in the 1891 contract (R. VI, 1935, 1936) to cover the use of the necessary exchange facilities, *inclusive* of the use of the local exchange plant and operating personnel in connection therewith, may have been a mere coincidence; or it may have been used to help to lend color to the misleading recital in the first paragraph of the 1919 Memorandum above quoted, to-wit: that it was merely "restating and reaffirming contractual relations."

C (2).

The 1919 Arrangement modified filed schedules of rates in force in Chicago.

1. 1889 Chicago Telephone Franchise.

The twenty year Chicago Telephone Franchise, accepted by the Chicago Company in 1889, limited the maximum rates to those in force in the City at the date of acceptance. In 1889 there was in force for $125 a year a flat rate service known as the "grounded line" service, which entitled the subscriber to unlimited exchange service, plus the unlimited right to use the local exchange plant and operating personnel in connection therewith to connect for local toll service (*Chicago Tel. Co.* v. *Ill. Mfg. Assn.*, 106 Ill. App. 54). To carry out the provisions of the Original License Contract of 1881 and the 1891 contract relating to long distance service the Chicago Company at great expense substituted metallic circuits for grounded lines from exchange stations to the central office (*Chicago Tel. Co.* v. *Ill. Mfg. Assn.*, 106 Ill. App. 54). This substitution resulted also in an improved local exchange service. The Chicago Company then offered the Chicago subscribers a "metallic circuit" service at a flat charge of $175 a year. This service gave to the subscriber the unlimited exchange service plus the unlimited right to use the local exchange plant and operating personnel in connection therewith to connect for local toll service to the same extent as had been given under the "grounded line" service, plus the unlimited right to use the local exchange plant and operating personnel in connection therewith in originating or in receiving long distance communications over the wires of the American Company. But the Chicago Company was enjoined from increasing its flat yearly charges beyond $125, the court holding that under the peculiar wording of the 1889 Telephone Franchise Chi-

cago subscribers could not be charged more than $125 per year for unlimited local exchange service plus unlimited right to use the local exchange plant for connections for local toll service, even though the services were now improved by the use of metallic circuits. On the other hand, the court held that the local exchange subscriber was not entitled, as part of the service for which the flat rate of $125 had been established, to the right to use, without extra charge, the local exchange plant and operating personnel in connection therewith for personal *long distance communications* over the wires of the American Company (*Chicago Tel. Co.* v. *Ill. Mfg. Assn.*, 106 Ill. App. 54).

From this it is clear that under the 1889 Telephone Franchise (a) the right by local exchange subscribers to use, in the *long distance service*, the local exchange plant and operating personnel in connection therewith, was *not included as part of the local exchange services;* (b) local exchange rates did not and could not legally absorb *the expenses of the use for long distance service of the local exchange plant and operating personnel in connection therewith* by customers of the local exchange service, and certainly not by non-customers of the local exchange service; and (c) such expenses were chargeable to the users of long distance service.

THE SITUATION IN CHICAGO ARISING FROM THE EFFECT OF THE 1889 TELEPHONE FRANCHISE DISTINGUISHES THE DEVELOPMENT OF LOCAL TOLL AND LONG DISTANCE RATES IN CHICAGO FROM THAT IN OTHER COMMUNITIES AND RENDERS THEIR EXPERIENCE INAPPLICABLE TO THE CASE AT BAR (*infra*, 79).

2. Rates 1907-1923.

The 1889 Telephone Franchise was in effect to 1907. A new telephone franchise was put into effect in Chicago in 1907 and another in 1913, establishing schedules of flat and

measured rates for local exchange service in Chicago. These schedules were in effect until June 16, 1919, when the Postmaster General put new rates into effect during the period of government control. In 1919, 1920 and 1923 the Public Utilities Commission and the Illinois Commerce Commission respectively approved various classes of local exchange rates. By the Franchise of 1913 the flat rate basis of charge was restricted to the then subscribers of that service. After 1919 only measured local exchange service was available in Chicago (R. VI, 2134, Exhibit A). The unit of measured service was defined as a call between stations located in Chicago of maximum duration not to exceed five minutes, and the amount of service was measured by the number of such unit calls (R. IV, 1219). During the period from 1907 to 1923 there were in force, from time to time, twenty-two different classes of local exchange service in the City of Chicago. In addition, there were eleven different kinds of charges for eleven different kinds of miscellaneous rights or privileges which might be had by some or all of the subscribers using any or all of the twenty-two different classes of local exchange service (R. VI, 2134, Exhibit A).

No document establishing local exchange rates in effect from 1907 to 1923 included or defined in any instance as part of the service for which the local exchange rate was established, and without additional charge, the right or privilege of the local exchange subscriber to make use of the local exchange plant and of the facilities of the Chicago Company necessary to establish the connection between his telephone station and the long distance switchboard or toll board of the American Company. Nor is any such right or privilege listed as available at a separate and distinct charge among the rights and privileges offered to users of the local exchange service in Chicago. Nor is any right or privilege given to any customer of the American Company who may or may not be a customer of any of the services

of the Chicago Company, or to the American Company itself, to the free use in the long distance service of the Chicago local exchange plant and operating personnel in connection therewith. Nor is there any provision by which the expenses of such use of the local exchange plant and operating personnel in connection therewith by the American Company and by its customers, who may or may not be customers of the Chicago Company or of the Chicago local exchange service, should be absorbed as part of the expenses of Chicago local exchange service.

The 1919 Memorandum established a new irrevocable arrangement whereby (1) the filed rates for local exchange service in effect in Chicago are made to absorb in perpetuity the entire cost of the free use in the long distance service of the Chicago local exchange plant and operating personnel in connection therewith, already detailed (*supra*, 38); and (2) the filed rates for local exchange service in effect in Chicago are made to absorb in perpetuity all or part of the difference between the cost to the Chicago Company of making available in the long distance service the balance of the Chicago necessary exchange facilities (other than the use of the local exchange plant and operating personnel in connection therewith), and the fixed minimum portion of the originating long distance revenue paid to the Chicago Company as compensation for the use of all such residuum of necessary exchange facilities.

D (1)

The compliance with the procedural requirements of the Illinois Public Utilities Act necessary as a condition precedent to making legally effective the 1919 Arrangement covering the use in the long distance service of the local exchange plant and operating personnel in connection therewith, was not made.

The 1919 Memorandum was executed and was made effective without the consent and approval of the Public Utilities Commission, and was not filed with the Commission before or after its execution or its effective date (R. V, 1785).

Section 27 Violated.

Section 27 of the Illinois Public Utilities Act in force since 1917 (Appendix, 63) prohibits a public utility from transferring, assigning, selling, or otherwise disposing of the whole or any part of its franchises, licenses, plant, equipment, business, or property without the prior consent of the Commission. The 1919 Memorandum violates this section in that:

(a) It is a perpetual grant of the free use of the Chicago local exchange plant and operating personnel in connection therewith to the American Company* and to those of its customers who are not customers of the Chicago Company and to those customers of the Chicago Company who are not customers of the local exchange service.

(b) It is a conveyance of part of the right of the Chicago Company to participate in the tolls and profits of long distance business transacted in Chicago in return for the

*Prior to July 1, 1917, no lease or grant could have been made to the American Company, a foreign corporation, even with the consent of the Commission (Illinois Laws 1917, p. 643).

use in the long distance service of all its necessary facilities located in Chicago.

Section 29 Violated.

Section 29 of the Act (Appendix, 65) requires the consent of the Commission to any contract with reference to or affecting the "franchise, license, permit or right to own, operate, manage or control any public utility." Under its Original License Contract of 1881, under its own Charter (R. V, 1860), and as a public utility in Illinois, the Chicago Company, after 1913 and before 1919, could offer and control the exchange service as its complete telephone service and could regulate the costs thereof and the rates therefor, subject to the provisions of the Public Utilities Act of Illinois. The new arrangement took away that absolute right and substituted therefor a *limited* right. After February 1, 1919, theChicago Company was obligated in perpetuity—(a) to *always cover by local exchange rates* the entire cost of giving the free use in the long distance service of the local exchange plant and operating personnel in connection therewith to the American Company, and/or to non-customers of the Chicago Company who are customers of the American Company, and/or to customers of the Chicago Company who are non-customers of the local exchange service but who are customers of the American Company; and (b) to always *apportion among all local exchange customers* of the Chicago Company part of the cost of the use by some local exchange customers of the local exchange plant and operating personnel in connection therewith in long distance service. The Chicago Company thereby *assigned its freedom to act as a public utility offering local exchange service in Chicago.*

Section 33 Violated.

Section 33 of the Act (Appendix, 66) requires that every public utility file with the Commission, print, and keep open on inspection, schedules showing all rates and other charges for any service performed by it. As part of such schedules there must be filed

> "all rules, regulations, * * * privileges and contracts that in any manner affect the rates charged or to be charged for any service."

The form of the schedules to be filed and posted is prescribed in Section 34 of the Act (Appendix, 67). Merely offering the 1919 Memorandum in evidence in this case is *not filing*, as prescribed by Sections 33 and 34 of the Act (Appendix, 66, 67). The 1919 Memorandum affected filed local exchange rates in that (a) it burdened them with the costs of serving non-subscribers of the local exchange service; and (b) it imposed upon Chicago local exchange subscribers who never use the long distance service a *new charge for a right to use the local exchange plant and operating personnel in connection therewith to connect with the long distance service*, which charge had not theretofore been covered by the Chicago local exchange rate since 1889.

Section 35 Violated.

By Section 35 of the Act (Appendix, 68) a public utility was required not

> "to perform any service or to furnish any product or commodity unless or until the rates and other charges and classifications, rules and regulations relating thereto, applicable to such service, product or commodity, have been filed and published in accordance with the provisions of this Act."

The Chicago Company has never *filed* and published the 1919 Memorandum nor any schedule showing the right of the American Company and of its customers who are non-

customers of the Chicago Company, and of customers of the Chicago Company who are not customers of the local exchange service, to use, free of charge, in the long distance service, the local exchange plant and its operating personnel in connection therewith (R. V, 1785). Nor has it filed and published any schedule showing that the right to use in the long distance service the local exchange facilities was a part of the services included in the various filed Chicago local exchange rates (R. V, 1785).

Section 36 Violated.

Section 36 of the Act (Appendix, 69) prohibits any public utility from making any changes in

> "* * * any rate or other charge or classification, or in any rule, regulation, practice, or contract relating to or affecting any rate or other charge, classification or service, or in any privilege or facility, except after thirty days' notice to the Commission and to the public as herein provided. * * * Such proposed changes must be plainly indicated on the new schedule filed with the Commission by some character to be designated by the Commission, immediately preceding or following the item."

By admission, the Chicago Company has not complied with this section (R. V, 1785). Nor has there been any order of the Commission waiving the requirement of the statute. Prior to 1919, the local exchange subscribers paid only for local exchange service. After 1919, all local exchange subscribers paid for local exchange service as used, plus the entire cost of donations of the use of the local exchange plant and operating personnel in connection therewith by *non-subscribers of the local exchange service* who are customers of the American Company. The local exchange subscribers who were not also customers of the American Company, in addition to paying the above extra charge, also paid part of the cost of the use in long distance service

of the local exchange plant and operating personnel in connection therewith by local exchange customers who are customers of the American Company.

D (2).

The 1919 Arrangement covering the use in the long distance service of the local exchange plant and operating personnel in connection therewith violates statutory substantive law.

Section 38 of the Illinois Public Utilities Act in force since 1917 (Appendix, 71) prohibits any utility from granting any preference or advantage to any corporation or person. The new arrangement violates Section 38 in that:

(a) It arbitrarily prefers non-subscribers of the Chicago local exchange service, who, as customers of the American Company, get free service at the expense of subscribers of the local exchange service who are not customers of the American Company;

(b) It arbitrarily prefers non-subscribers of the local exchange service, who, as customers of the American Company, get free service at the expense of subscribers of the local exchange service who are also customers of the American Company. The latter absorb their pro rata portion of the cost of their own use in the long distance service of the local exchange plant and operating personnel in connection therewith (*Southern Bell Tel. & Tel. Co.* v. *R. R. Com. of Georgia*, 274 Fed. 438; certiorari denied, 262 U. S. 761);

(c) The subscribers of the local exchange service who are customers of the American Company, are arbitrarily preferred over the subscribers of the local exchange service who are not customers of the American Company. The latter absorb part of the cost of rendering service to the

former. There are twenty-two classes of local exchange service (R. VI, 2134; Exhibit A). It is common knowledge that only a small percentage of local exchange subscribers are the large users of long distance service. It is unfair to compel *all subscribers for local exchange service* to pay for a *right to use* the local exchange plant and operating personnel in connection therewith for a special use unless the probability of the exercise of the *right to that special use is distributed generally among such subscribers.**

(d) The users of the local toll service of the Chicago Company are arbitrarily preferred over the subscribers of the local exchange service. The original long distance arrangement embodied in Section 10 of the Original License Contract of 1881 was part of the consideration for the grant to the Chicago Company of licenses for both local exchange and local toll services (*supra*, 40). Any loss to the Chicago Company resulting from the use in long distance service of any part of its necessary facilities would be an expense common to both the local exchange and local toll services and subject to apportionment between them. The new arrangement which required the Chicago Company in perpetuity to cover by its exchange rates the entire loss, created an arbitrary discrimination in favor of the local toll service.

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*The State Public Service Commission of Oregon found that where the cost to the exchange of making available its necessary facilities for the toll service is in excess of the revenue received by the exchange through the originating commission, "a discrimination in rates is constituted in favor of large toll users and against the majority of local subscribers adversely affecting approximately 70% of the telephone users." (In *Re Pacific Tel. & Tel. Co.*, P. U. R. 1923 A, 531).

D (3)

The 1919 Arrangement is not such an act of management as should be sanctioned.

1. Failure to Exercise Judgment of Ordinary Business Men.

The minimum obligation of the managing officers of the Chicago Company to the community served is to act as ordinary business men. Under Section 10 of the License Contract of 1881, it was their duty to demand that all arrangements should provide for a "reasonable and suitable division of the tolls and profits" of the long distance service in Chicago to cover the use of all the property and all of the services of the Chicago Company used in that service in Chicago (R. VI, 1929).

The board of directors of the Chicago Company did not act as ordinary business men in entering into the 1919 Arrangement, by which they gave to the long distance service of the American Company, in perpetuity, the free use of the former company's local exchange plant and operating personnel in connection therewith. The reasons are:

1. No study was ever made to determine the cost to the Chicago Company of granting the use of its facilities for long distance service. The directors gave to non-customers the free use of property and personnel without even knowing the extent of its burden. Such studies are practicable (*infra*, 110) and have been made by other companies including the New York Telephone Company (R. II, 847).

2. Prior to 1919 the American Company had the obligation to pay rent for the use of the Chicago local exchange plant. Presumably the long distance rates absorbed such cost.* The 1919 Arrangement did not require the

*Long distance rates apparently still cover connections between stations (R. VI, 2319).

American Company to reflect the saving in rent in its long distance rates. In the absence of a showing that the American Company had done so, the new arrangement resulted only in additional net profits. But there was no showing that the American Company was not already earning reasonable returns from the long distance service. Nor was there any showing that the long distance rates were not then sufficient to give to the two companies a fair return on their respective investments plus reimbursement for all actual expenses incurred by each in the long distance service. If the American Company did reflect the savings of rent in its long distance rates, this benefit might go to persons who had never been, who were not then, and who might never become customers of the Chicago Company. What is there so exalted in being a customer of the American Company that he is entitled to a gift of the free use of a portion of the facilities of the Chicago Company at the expense of the Chicago local exchange customers?

3. No machinery has been set up to determine from time to time how much the new arrangement will burden the local exchange service; nor to permit revision of the arrangement, should experience disclose that it is too burdensome to the Chicago local exchange customers and/or unduly preferential to the customers of the American Company, who may be non-customers of the Chicago Company.

2. The Management in 1918-1919 Held Interests Adverse to those of Local Exchange Customers.

Still another factor must be considered in weighing the new arrangement as an act of management.

In 1918 all but 7,184 of the 400,000 outstanding shares of the Chicago Company were owned by the American Company (R. VI, 1982, 2120). Under such circumstances, close scrutiny of the facts surrounding the arrangement is re-

quired by law (*City of Houston* v. *Southwestern Bell Tel. Co.*, 259 U. S. 318 (hereinafter referred to as *Houston Case*)).

Such close scrutiny discloses the following:

(a) In 1918 the Chicago Company was one of five Bell Companies organized by the American Company into one operating unit known as the Central Group, each Company, however, at the same time, to preserve for itself its separate corporate existence (R. VII, 2574 (37); R. VI, 2063).

By this arrangement (R. V, 1588) at least twenty-five officers and employees of each of the five companies were the same individuals, including the President, Vice-President, Secretary, Treasurer, General Counsel, General Auditor, and Chief Engineer, as well as the various clerks and assistants in each of said departments (R. VI, 2063); many of the directors were the same for each company (R. V, 1588); the salaries of these officials and employees and the expenses of their departments were distributed among the group and could be paid by check of any of the five companies (R. VI, 1989, 2063). This grouping of companies and personnel was in furtherance of the program of the American Company from 1908 to 1918 to provide a unified nation-wide telephone service, with the American Company as the responsible head, without limitation of property ownership and without limitation of legal restraints incident to the management of the affairs of the licensee companies as separate and distinct corporate entities (*infra*, 255).

The function of each of the companies in this Central Group was clearly defined by the American Company:

> "All questions of policy common to all, all common matters which may have an effect upon the system as

a whole, will be settled by the Central Administration (American Company). As one administration will do for all what each would have to do for itself, it has the advantage of economy and will maintain uniformity."

* * * * *

All lines of responsibility and suggestion will go up from the local representatives to the Central Administration. All lines of authority down, from the Central Administration to the local chief." (R. VII, 2476 (26), 2477 (28).)

It is obvious that under such a plan of operation the freedom of action of the management of the Chicago Company to act for the sole benefit of the community served by it was taken away.

(b) Transfer of allegiance of employees from Chicago Company to the Bell System.

As part of the same program of unification, the American Company itself, beginning with 1912, undertook the internal re-organization of the Chicago Company. This re-organization was accomplished by 1918 in three steps:

(1) *Employees' Benefit Plan.*

In 1912 the American Company entered into an identical contract with the Western Electric, the Western Union, and each of the Associated Companies of the Bell System, including the Chicago Company, by the terms of which contract each of these companies agreed to accept the Plan for Employees' Personal Disability Benefit and Insurance, adopted by the American Company. Under this plan *the term of employment, which regulates the amount of benefit to be received, is determined by the total period of employment in any or all the companies of the Bell System and not by continued employment in the same company only from which benefit is sought.* The American Company

underwrote the Plan with a special guaranty fund to be distributed among the parties to the plan, under certain conditions specified by and subject to the sole discretion of the American Company (R. VII, 2486-7 (17,18); R. VI, 2001-2006). The purpose of this plan, the American Company declared, was "the unifying of the various interests so that *any employee may aspire to work anywhere in the country with uninterrupted benefits, and any company can obtain any man it needs, without prejudice to his welfare*" (R. VII, 2488 (19)). It is obvious that under this plan each of the employees of the Chicago Company was considered and considered himself an employee of the Bell System as an entity and that his allegiance was transferred from his own company to the Bell System as a whole (R. VI, 2001, 2006).

(2) *Employees' Stock Plan.*

Beginning with 1914 the American Company by arrangement with the Bell licensee companies sold to their employees American Company stock on the installment plan, the installments to be collected and transmitted by such companies (R. VI, 2031; R. VII, 2513 (17)). From 1915 to 1918 approximately 25% of all the employees of the Chicago Company had subscribed to approximately 40,000 shares of stock of the American Company, and those who had not subscribed had before them the privilege so to do (R. VI, 2318). It is therefore ridiculous to assume or to believe that employees of the Chicago Company would take an independent stand against the American Company in favor of the local community in any case in which the interests of the two companies conflicted or were adverse.

(3) *Personnel of Management.*

In 1911 the Chicago Company had 1,382 stockholders, excluding the American Company, which still owned 52.03%

of the stock (R. VI, 1982). Nine of the eleven directors on the Board of Directors in 1911 owned 6,720 shares; two held qualifying shares of the American Company (R. VI, 2191). To avoid "conflicting interests" with the minority stockholders in the carrying out of its program, just described, of territorial grouping into the Central Group and of unification, the American Company in 1911 acquired practically all such minority stock (R. VI, 1982). In 1912 the Chicago Company had 145 stockholders, one of whom, the American Company, held 97.47% of the stock (R. VI, 1982). Of the eleven directors holding office in the Chicago Company from 1912 to 1918, seven or eight directors always held in their own names of record, shares of stock of the American Company, while the total aggregate stockholdings of the other directors have at no time since 1911 exceeded 65 shares (R. VI, 2191). In 1918 the number of shares of the Chicago Company outstanding was 400,000 shares, of which the American Company owned all but 7,800 shares. These 7,800 shares were distributed among 128 stockholders (R. VI, 1982). In the same year, eight directors of the Chicago Company held qualifying stock from the American Company. The other three directors owned four shares, five shares, and twenty shares, respectively (R. VI, 2191). Of the eight directors who held qualifying stock, one was the President of the American Company, and another was Senior Vice-President and director of the American Company; two of the other eight directors were the President and a Vice-President of the Chicago Company, who were the only two directors actively identified with the business of the company. These two directors held corresponding offices in the four other Bell telephone companies of the Central Group (R. VI, 1989; R. V, 1588).

The President who signed the Memorandum had been Vice President of the American Company in 1908. In that year he was placed in charge as President of the Chicago

Company, and continued in his capacity as Vice-President from 1908 to 1911, at a salary paid to him by the American Company. Although he became President of the five companies of the Central Group in 1911, and director of the Chicago Company, he continued as Vice-President of the American Company until 1915, at a combination salary, part of which was paid by and apportioned between the Central Group companies and part of which was paid by the American Company under a secret arrangement made in July, 1912, between him and the Senior Vice-President of the American Company, who, as already noted, was also a director of the Chicago Company in 1918 (R. V. 1588; R. VI, 2190). After 1915 he continued as President of the five Central Group companies and as director of the Chicago Company (R. V, 1588).

It is, of course, an illusion to assume or to believe that such management was qualified to deal with the American Company in the interests of the local exchange customers. The facts surrounding the execution of the 1919 Memorandum are such as to justify its rejection as an act of management.

D (4)

The 1919 Arrangement is contrary to the practice of the Chicago Company covering its local toll and exchange rates in force in Chicago.

The Statutory Court approved the 1919 arrangement upon the authority of a section of the Local Toll Rate Schedules of the Chicago Company filed September 1, 1926, R. I, 186). This section purports to limit the services covered by the local toll rates by excluding therefrom the use in such services of the local exchange plant and operating personnel in connection therewith, and by reciting that such

use is covered by the charges for exchange service (R. I, 186; R. IV, 1271). This section has never been legally in force. The 1889 Chicago Telephone Franchise established *exchange flat rates* for the unlimited right to use the exchange plant and operating personnel in connection therewith in exchange service in Chicago, plus the unlimited right of exchange subscriber to use without separate charge the same local exchange plant and operating personnel in connection therewith for his local toll communications. The Franchise, however, neither created the obligation on the same exchange customer to absorb the cost of use by non-subscribers of the local exchange service of the local exchange facilities for their local toll communications, nor conferred the right on such non-subscribers to make such use of exchange facilities for toll communications (*supra*, 53).

Since the expiration in 1907 of the 1889 Franchise, the Chicago exchange rate structure has been established largely on the measured service basis (R. VI, 2130). In 1913 the flat rate schedules were limited to be available only to those who had already subscribed to flat rate services; since 1919 only measured service has been in force in Chicago (R. IV, 1283). By Section 33 of the Public Utilities Act in effect January 1, 1914, (Laws of Illinois, 1913, p. 476) the Chicago Company was required to file, as of that date, schedules showing all charges and classifications for every service performed by it. The record shows all the various exchange services and all the rates charged therefor from 1914 to 1928 (R. VI, 2134, Exhibit A; R. IV, 1218). The schedule defines the exchange service as the right to use the exchange facilities to transmit personal communications between subscribers' stations located in the City of Chicago, the extent of the exercise of that right determining the amount of charge (R. IV, 1271). There is no declared right given

(and the definition of exchange service necessarily excludes any inferred right) to the local exchange subscriber to use, as part of the services for which his exchange rate is established, the local exchange facilities necessary to transmit personal communications between his telephone station and those of subscribers of other exchanges outside the City of Chicago within the territory of the Chicago Company. Nor is there declared or inferred in such schedules any right to a non-subscriber of exchange service to use for local toll service without extra charge the Chicago local exchange plant and operating personnel in connection therewith.

Although the Chicago Company filed, to become effective October 1, 1926, an amendment to its toll rate schedules reciting that the services covered by toll rates were not intended thereafter to cover the use of the local exchange plant and operating personnel in connection therewith, such use being covered by exchange rates (R. IV, 1271), the toll rates themselves were not revised to eliminate therefrom the charge theretofore made to the local toll customer to cover the use of such local exchange plant and operating personnel in connection therewith. It is doubtful therefore whether the recital has any effect whatsoever even as to the toll rate structure. No showing was made that any filed document prior to 1926 contained any recital such as was contained in the amended sheet filed at that time. The mere fact that in 1926 the Chicago Company filed a revised toll schedule reciting that the toll charge was not intended to cover the use in the local toll service of the local exchange plant and operating personnel in connection therewith, by implication negatives the prior existence of any such intention.

The recital in the local toll schedules alone would not revise exchange service to cover, by the Chicago exchange

rates, part of the cost of the local toll service (Section 30, Appendix, 65). The recital in the local toll schedule was, therefore, legally ineffective to affect the Chicago local exchange rates. The 1919 Arrangement was in 1919 and has continued to be contrary to the practice of the Chicago Company relating to its own services and legally in force in Chicago.

But assuming that the section of the local toll schedule cited by the Statutory Court were legally in force, it is no justification for the same revision where the long distance service is not its complete service. The reasons and authorities in support of our contention are fully set forth (*infra,* 79).

D (5)

The 1919 Arrangement is contrary to the arrangement between the Chicago Company and 293 independent connecting companies in the State of Illinois.

For over ten years prior to March 1, 1920, traffic agreements between the Chicago Company and independent connecting companies provided for an originating commission to each company, and a distribution of the balance upon a basis agreed upon (R. IV, 1328). There is nothing in the record to indicate that the use of the local exchange plant and operating personnel in connection therewith was not intended to be covered either by the connecting company rates or by the settlement between the parties. In 1920, new traffic agreements were made effective between the Chicago Company and 293 independent telephone companies in Illinois. The agreements provide for an originating commission to each company, and a distribution of the balance of the charge on a basis therein specified. These agreements on their face show clearly that the use of all necessary exchange facilities, including the local exchange

plant and operating personnel in connection therewith, was intended to be covered by the originating commission. (R. IV, 1351, 1364). Although the traffic agreements were modified within the following year (R. IV, 1351), as to the basis on which the originating commission should be established, no change was made in the provision to the effect that the use of all necessary exchange facilities, including the local exchange plant and operating personnel in connection therewith, should be covered by the originating commission. Both the traffic agreement of 1920, and the modification thereof, and the arrangement between the Chicago Company and 293 independent telephone companies in Illinois in conformity therewith, were approved by the Illinois Commerce Commission (R. IV, 1351). The 1919 Arrangement is contrary to such arrangements.*

*Beginning with 1926 new traffic agreements were made, the form of contract, however, not being in the record (R. IV, 1328). The basis on which the originating commission was established by the earlier agreements was changed. A notation by the Chicago Company in the Exhibit summarizing the provisions of such new agreements states that the originating commission as established was not intended to be compensation for the use in the connecting company service of the local exchange plant and operating personnel in connection therewith, as such service was to be covered by the Exchange rates of the respective parties. But it does not appear that the new agreements were filed with or were approved by the Illinois Commerce Commission to replace the previous agreements which had been approved and filed, nor that any change was made in the connecting company rates of either party to exclude therefrom compensation for the use in the connecting service of their respective local exchange plants and operating personnel in connection therewith. No change was made in the filed schedules of the Chicago exchange rates by which they were made to absorb the cost of use in the connecting company sense of the Chicago Company of the Chicago local exchange plant and operating personnel in connection therewith (R. IV, 1218).

D (6)

The 1919 Memorandum is contrary to the arrangement between the Chicago Company and other associated companies of the Bell System.

WISCONSIN TELEPHONE COMPANY.

Prior to 1910 the settlement between the Chicago Company and the Wisconsin Telephone Company provided that neither company receive any originating commission, but that the Chicago Company receive 80% of all revenues of interconnecting business originating in or received by either company (R. IV, 1334). Beginning with 1910 each company received an originating commission on the basis of a percentage of the toll charge; the distribution of the balance was on a basis agreed upon. Nothing appears in the record to indicate that the use of the local exchange plant and operating personnel in connection therewith was not intended to be covered either by the connecting company rates or in the settlement between the companies (R. IV, 1328).

INDIANA BELL TELEPHONE COMPANY, CENTRAL UNION TELEPHONE COMPANY AND SOUTHWESTERN BELL TELEPHONE COMPANY.

The Chicago Company from time to time had connecting company arrangements with the Central Union Telephone Company, the Indiana Bell Telephone Company and the Southwestern Bell Telephone Company. In each case the settlement with the Chicago Company provided for an originating commission. In no case was there anything to indicate that the use of the local exchange plant and operating personnel in connection therewith was not intended to be covered either by the connecting com-

pany rates or by the settlement between the parties (R. IV, 1328, 1337, 1341).

D (7)

The 1919 Arrangement is contrary to the general practice in force between separate telephone companies and between separate services of the same telephone company, within and without the Bell System, and has been generally disapproved by the authorities.

The Statutory Court approves the reasonableness of the 1919 Arrangement on the authority of *Re Rock County Farmers Tel. Co.*, P. U. R. 1925 A, 178 (Wisconsin); *Public Utilities Com.* v. *New England Tel. and Tel. Co.*, P. U. R. 1926, C. 207 (Rhode Island); *Pacific Tel. and Tel. Co.* v. *Whitcomb*, 12 Fed. (2nd) 279; *New York Tel. Co.* v. *Prendergast*, 300 Fed. 822, 826, 827, and the same case on final hearing [36 Fed. (2nd) 54; (R. I, 186). Its use of these cases as authority clearly indicates the failure of the Statutory Court to grasp the fundamental issues in the instant case.

ERROR OF STATUTORY COURT.

The foundation upon which the Statutory Court's error rests is its failure to distinguish between cases where the extra-territorial service is offered as the complete service of the Exchange Company and cases where it is offered as the complete service of another company, and its failure to recognize the difference between the terms of Section 10 of the Original License Contract of 1881 and the corresponding provisions covering long distance service contained in the Standard Bell license contracts.

Discussion.

SUMMARY OF AUTHORITIES.

The authorities covering the proper relationships of exchange and extra-territorial rates are of two broad classes:

Class A. Where the same utility offers both exchange and toll services as its own complete services, and its rates and the particular practice involved in determining them are subject to the jurisdiction of the same regulatory body.

Class B. Where (as in the instant case) the exchange and extra-territorial services are offered as the complete services of two separate companies, whose rates and the particular practice involved in determining them are not subject to the jurisdiction of the same regulatory body.

Class A.

WHERE THE SAME UTILITY OFFERS BOTH EXCHANGE AND TOLL SERVICE AS ITS OWN COMPLETE SERVICES, AND ITS RATES AND THE PARTICULAR PRACTICE INVOLVED IN DETERMINING THEM ARE SUBJECT TO THE JURISDICTION OF THE SAME REGULATORY BODY.

Summarizing the cases in this class we find:

I.

The practice in the majority of the jurisdictions in 1918 was and has since continued to be that the extra-territorial rates and the portion of toll revenue allocated to the exchange service are *both intended* to cover the use of all necessary exchange facilities, including the use of the local exchange plant and operating personnel in connection therewith. This practice has prevailed since 1914 in the territory of the Chicago Company (*supra*, 70), and generally throughout the United States (*Houston* case, 259 U. S. 318, *infra*, 96), including the territory of the New York

Telephone Company (R. II, 847). **Yet the Statutory Court cites New York Telephone Co. v. Prendergast, 300 Fed. 822, as authority to support the 1919 Arrangement, where no such intention exists.***

The compensation to the exchange service is usually established on the basis of a percentage of the gross toll revenue originated in the respective exchanges.** Such percentage may or may not bear relation to the cost of making available for use in the local toll service all of the necessary exchange facilities. Where reviewing authorities having the necessary jurisdiction are asked in proper manner to review the reasonableness of the percentage of revenue allocated, the ordinary rules of evidence and procedure are applied in its determination (*Stone* v. *New York Tel. Co.*, P. U. R. 1921 D, 736 (New York)). As a test for reasonableness the reviewing authority may examine the relation of the allocated revenue under investigation to allocations made for the use of similar exchange facilities under contracts where the exchange and extra-territorial services are operated by separate independent companies (*Houston case*, 259 U. S. 318); or the reviewing authority may examine the relation of the allocation under

*In the New York Telephone case, the only reference to the issue of the propriety of covering by the exchange rates the cost of the use in long distance service of the local exchange plant and operating personnel in connection therewith, appears in the Order of the New York Board of Public Utility Commissioners of January 25, 1923. As reported, the reference is unintelligible. It states: "It is true that under this contract no specific payment is made for the use of the subscriber's line, or that portion of the exchange switchboard involved in the handling of a toll call, yet it is undisputed that it is the universal practice among telephone companies to base such payments on outgoing calls and the amount paid is almost universally held to cover both incoming and outgoing calls" (*Re New York Tel. Co.* P. U. R. 1923B, 545, 590) (New York).

**Another basis of allocation is: all of the net toll revenue remaining after a deduction of the costs directly chargeable to the toll service, including a fair return on the exclusively used toll property, may be divided among the exchanges either in proportion to their respective originating toll calls (*Re Michigan State Tel. Co.*, P. U. R. 1923 A, 30 (Michigan): *Re Central Union Telegraph Co.*, P. U. R. 1920 B, 813 (Indiana)), or on the basis of their investment in the exchange systems (*In re Application Interurban Tel. Co.*, 6 Wis. R. C. R. 647 (Wisconsin, 1911)).

investigation to the actual costs of the use in the local toll service of the necessary exchange facilities (*Re Mo. and Kan. Tel. Co.*, P. U. R. 1918 C, 55 (Kansas)). If the allocation is found to be inadequate, the authorities require either that the allocated revenue be increased (*Re Pacific Tel. & Tel. Co.*, P. U. R. 1923-A, 531 (Oregon)) or that all the necessary exchange facilities and expenses properly apportionable to the local toll service, together with the portion of the toll revenue allocated thereto, be excluded from the exchange property, revenues, and expenses for exchange rate making purposes (*Re Mo. and Kan. Tel. Co.*, P. U. R. 1918 C, 55 (Kansas)).

II.

Where the local toll charge and the allocated portion of the local toll revenue are *not intended by the Management to cover the use in the local toll service of the local exchange plant and operating personnel in connection therewith*, the practice has not been sanctioned by the authorities (having the necessary jurisdiction and having the act of management properly presented for review), unless there exist in the particular case under investigation special facts requiring that practice instead of the general practice prevailing elsewhere (*Re Mo. and Kan. Tel. Co.*, P. U. R. 1918 C, 55 (Kansas); *Re Chesapeake & Potomac Telephone Co.*, P. U. R. 1926 E, 481 (Virginia); affirmed. 147 Va. 43, 136 S. E. 575). **Such offsetting special facts appear in the case of Public Utilities Com. v. New England Tel. & Tel. Co., P. U. R. 1926 C, 207, 234 (Rhode Island)**, cited by the Statutory Court. In that case uniformity was required because the company had previously established in part of its territory (beyond the jurisdiction of the reviewing authority) toll rates on the basis of covering with exchange rates the use of the local exchange plant and operating personnel in connection therewith.

CONCLUSIONS AS TO CLASS A.

1. The practice prescribed by the 1919 Memorandum of including as part of the costs of the exchange service the costs of making available in an extra-territorial service the local exchange plant and operating personnel in connection therewith, was in 1918 and has since continued to be contrary to the general practice prevailing in the territory of the Chicago Company and in the United States where the two services are operated by the same company. The minority practice has been sustained only where special facts appear.

2. The authorities which sustain the minority practice cannot be used to sustain a similar practice in the case of long distance service for the reason that there is a fundamental distinction between the Class A and Class B situations; the former where the exchange operator also offers the extra-territorial service as its own complete service; the latter where the two services are complete services of separate companies. The distinction between the two situations is generally recognized (*Re Southern Cal. Tel Co.*, P. U. R. 1925 C, 627, 654 (California)). In the first class the utility receives all of the revenue from both services; its rates and practices for both are subject to the jurisdiction of the same commission, which has power of revision thereof. Rate structures for all services offered as the complete services of the same company are now universally established on a statewide or company basis. Every fact relative to the Company's entire business is investigated, including the amount of revenue necessary to yield a fair return on the entire property of the Company (*Re New York Telephone Co.*, P. U. R. 1922 A, 497, 502 (New York)). There is assured to the utility the benefit of all the revenue of the toll service, no matter how the apportionment is made between the exchanges, of the terminal commission

and balance of the revenue (*Re New England Tel. & Tel. Co.*, P. U. R. 1926 B, 247, 286-7 (Maine). But the consideration of rates on a statewide or company basis assures to the utility only one fair return on its capital* (*Stone* v. *New York Tel. Co.*, P. U. R. 1921 D, 736, 757 (New York); *Re New York Telephone Co.*, P. U. R. 1923 B, 545, 590 (New York); *Re New York Telephone Co.*, P. U. R. 1922 A, 497, 502 (New York); *Public Service Com.* v. *Mountain States Tel. & Tel. Co.*, P. U. R. 1924 C, 545, 556 (Montana); *Re Uniform Telephone Rates*, P. U. R. 1917 D, 259, 261 (Pennsylvania); *Re Chesapeake & Potomac Telephone Co.*, P. U. R. 1916 C, 925, 1002 (Maryland); *Re Michigan State Telephone Co.*, P. U. R. 1918 C, 81 (Michigan)). The utility therefore receives no additional profit for itself or for its stockholders by establishing local toll or exchange rates on the basis of including as part of the one or of the other the cost of use in the local toll service of the local exchange plant and operating personnel in connection therewith. The allocation of the property, revenue and expenses between the two services in conformity with the basis on which the rates were established, does not involve a gain or loss of revenue to the utility. If the local exchange service pays part of the cost of furnishing the local toll service, the benefit to the local toll user who is not a local exchange customer may be offset to the local exchange service by the greater revenue from stimulated toll service. The increased prosperity of the company leads to more efficient service at lower rates

*The instant case presents a singular condition. Prior to 1921 the Chicago Company had the original territory granted under the Original License Contract of 1881 (R. VI, 1925). Rates for exchange and toll service were arranged in 1920 on the basis of yielding a fair return on the investment in that territory (R. IV, 1306). Since 1921 the Central Union territory has been added (R. IV, 1427). There has been no case involving rates for the Chicago Company on a statewide or company basis as in New York State. But all the rates of the Chicago Company are before the Illinois Commerce Commission. It has power to readjust them. The principles established in the text are therefore applicable.

to the local exchange customer. The rates and practices of one or of the other of the two services can be revised from time to time by the utility itself, or by the regulatory body, to prevent any undue burden on the one or unfair preference to the other of the two services. The development of the present local toll and exchange rate structures of the New York Company is an example of such readjustment.*

The situation is, however, different in the second class, where, as in the instant case, the exchange and extra-territorial services are offered as complete services of two separate companies. In this case all that the operator of the exchange service ever receives is the allocated portion of the extra-territorial service that is rendered. The allocation of property, revenues, and expenses between the two services, made in conformity with the basis on which the rates are established, involves a loss or gain of revenue to the one and a corresponding gain or loss of revenue to the other of the two companies. In the absence of contractual provisions there is no assurance that the inclusion in the exchange charges of the cost of the use in extra-territorial service of the local exchange plant and operating personnel in connection therewith will not result in an additional profit to the operator of the extra-territorial service at the expense of the local exchange service. The rates of the former service may cover that very use already covered by the exchange rates. In the absence of proof to the contrary, the presumption is that the extra-territorial service rate covers the use of each and every part of the facilities necessary to render that service (*Southern Bell Tel. & Tel. Co.* v. *R. R. Com. of Georgia*, 274 Fed. 438; certiorari denied, 262 U. S. 761). Without contractual provision there is no power to readjust the charges

*Compare the basis of relationship of the Company approved in *Stone* v. *New York Tel. Co.*, P. U. R. 1921 D 736 (New York), with the basis used thereafter as described in R. II. 847.

of the two services so as to prevent at any time any undue burden on the one or unfair preference to the other of the two services. If the local exchange customer pays for part of the extra-territorial service, the benefit received by the customer of the latter service who is not a customer of the exchange service, is not offset to the local exchange service by any more efficient local exchange service from the increased prosperity of the operator of the extra-territorial service arising from its stimulated business.

From the above considerations, it is evident that the approval in the first class of cases such as *Public Utilities Com.* v. *New England Tel. & Tel. Co.*, P. U. R. 1926 C, 207, 234 (Rhode Island), cited by the Statutory Court (R. I, 186), of the inclusion in exchange charges of the cost of use in the local toll service of the local exchange plant and operating personnel in connection therewith, is no authority for the approval of a similar inclusion in the Chicago exchange rates of the cost of the use in the long distance service of the American Company of the Chicago local exchange and operating personnel in connection therewith.

Class B.

WHERE (AS IN THE INSTANT CASE) THE EXCHANGE AND EXTRA-TERRITORIAL SERVICES ARE OFFERED AS THE COMPLETE SERVICES OF TWO SEPARATE COMPANIES, WHOSE RATES AND THE PARTICULAR PRACTICE INVOLVED IN DETERMINING THEM ARE NOT SUBJECT TO THE JURISDICTION OF THE SAME REGULATORY BODY.

Summarizing the cases in this class, we find:

1. EXTRA-TERRITORIAL CONNECTING SERVICE.

Where the extra-territorial connecting service is not the long distance service of the American Company, the

practice of the Chicago Company, in its relations with 293 independent telephone companies and with other Bell licensee companies (*supra*, 72, 74), and the general practice in the United States, was in 1918 and has since continued to be that the extra-territorial connecting rates and the portion of the extra-territorial connecting revenue allocated to the exchange service *were intended* to cover the use in such service of all necessary exchange facilities (*Houston Case*, 259 U. S. 318; *Southern Bell Tel. & Tel. Co.* v. *R. R. Com. of Georgia*, 274 Fed. 438; certiorari denied, 262 U. S. 761; **Pacific Tel. & Tel. Co. v. Whitcomb, 12 Fed. (2nd) 279). Yet the Statutory Court erroneously cites this last case as authority for the 1919 Arrangement.**

Where the reviewing authorities having the necessary jurisdiction are asked in proper manner to review the reasonableness of the amount of revenue allocated the ordinary rules of procedure and evidence are applied in its determination (*Pacific Tel. & Tel. Co.* v. *Whitcomb*, 12 Fed. (2nd) 279; *Southern Bell Tel. Co.* v. *R. R. Com. of Georgia*, 274 Fed. 438; *certiorari* denied, 262 U. S. 761).

Where such allocated portion is *not intended* by the Management of the Exchange Service to cover the use in the extra-territorial service of the local exchange plant and operating personnel in connection therewith, the practice has not been generally sanctioned by the authorities (having the necessary jurisdiction and having the act of management properly before them for review) (*Southern Tel. & Tel. Co.* v. *R. R. Com. of Georgia*, 274 Fed. 438; certiorari denied, 262 U. S. 761; *Re Southern Cal. Tel. Co.*, P. U. R. 1925 C, 627 (California); *Re Mo. and Kan. Tel. Co.*, P. U. R. 1918 C, 55 (Kansas)).

When the practice has been sanctioned, the sanction has been based on specific facts, such as: (a) the misconception of the telephone service through its treatment on the same

basis as telegraph service (*Tri-County Tel. Co.* v. *Gandy Switchboard Co.*, P. U. R. 1920 B, 760 (Nebraska); or (b) the lack of accounting facilities of rural companies to enforce complicated structures necessitating the establishment of a *flat rate exchange service to* cover all uses of exchange facilities **(Re Rock County Farmers Tel. Co., P. U. R. 1925 A, 178 (Wisconsin)). Yet this case is cited by the Statutory Court as authority.**

The 1919 Arrangement, which included as part of the cost of the exchange service the cost of making available in the long distance service the Chicago local exchange plant and operating personnel in connection therewith, is therefore contrary to the practice followed by the Chicago Company and to the universal practice in the United States, in cases where the exchange and extra-territorial service (other than long distance service) are offered as the complete services of two separate companies.

2. STANDARD LONG DISTANCE ARRANGEMENT.

As appears in the following analysis, prior to 1918 the irrevocable Standard arrangement between the exchange service of the operating companies of the Bell System and the American Company provided for the allocation to the exchange service of a fixed portion of the long distance revenue originated in such exchange as compensation for the use in the long distance service of all necessary exchange facilities. After 1918 the standard arrangement was revised by mutual consent to provide that the same fixed portion of originating long distance revenue as had previously paid for the use in that service of all necessary exchange facilities, should thereafter be considered as payment for the use in the same service of all necessary exchange facilities excepting the use of the local exchange plant and operating personnel in connection therewith (the cost of which

latter use was to be included as part of the exchange charges). Of the reviewing authorities, one refused to sanction the revision (*Re Chesapeake & Potomac Tel. Co., P.* U. R. 1926 E, 481 (Virginia); Affirmed, 147 Va. 43, 136 S. E. 575; and two purported not to disturb or to pass on the revision (*Chesapeake & Potomac Tel. Co.* v. *Whitman,* 3 Fed. (2) 938, 957; *Re New York Tel. Co.,* P. U. R. 1923 B, 545, 589 (New York)).

The Statutory Court and the Chicago Company seek to support the 1919 Memorandum on the basis of these latter two authorities and on the fact that the 1919 Memorandum embodies the identical revision made and accepted by the exchange operators in the balance of the Bell System (R. I, 187). The following analysis, however, proves conclusively that not only are the authorities which cover the standard situation inapplicable to the issue now under discussion, but (more important still) that the act of the Chicago Company in permitting the revision of its special arrangement under the Original License Contract of 1881 to conform to the revised standard arrangement covering the use of the local exchange plant and operating personnel in connection therewith, perpetuated a gross imposition on the Chicago local exchange customers. The reasons are:

(a) THE CHICAGO LICENSE CONTRACT OF 1881 DIFFERS SO RADICALLY FROM THE STANDARD FORMS OF EXCHANGE AND TOLL CONTRACTS ISSUED TO THE OTHER OPERATING COMPANIES OF THE BELL SYSTEM AS TO RENDER THEIR EXPERIENCE WHOLLY INAPPLICABLE TO THE CASE AT BAR.

FORM 109D—CONTRACT FOR EXCHANGES.

The standard forms of license contracts were part of the record before this Court in the *Houston Case,* 259 U. S. 318 (Rec. *Houston Case,* Vol. II, 878-895), and are repro-

duced in the appendix hereto (pp. 7, 18, 29).* Separate license contracts were given for exchange service and for extra-territorial connecting service. Exchange contract form 109D granted a perpetual license to do a telephone business in exchange systems only, and then only in those located within specified areas (Exchange Service). As royalty for this limited use the licensee paid a portion of the gross instrument rental charged its exchange subscribers. For extra-territorial connecting service of any kind the exchange licensee was obligated: (a) to turn over all such messages originating from customers at exchange stations to the American Bell (or its grantees) exclusively. This latter company was to have the right to prescribe the rates to be charged and to make use of the exchange facilities to route the messages from the station through the exchange offices onto the wires of the American Bell (or of its grantee); (b) to bill, collect, and settle the toll account; (c) to permit the use of the exchange facilities for the purpose of completing messages coming over the wires of the American Bell (or of its grantee) to its customers at exchange station; (d) to accept as full payment for all of the above exchange services rendered to the extra-territorial connecting service 15% of the tolls of messages originating within the exchange sys-

*In State ex rel. Southwestern Bell Tel. Co. v. Public Service Commission of Missouri, 262 U. S. 276 (hereinafter referred to as *Missouri Case*) reference is made to the standard forms in connection with the Original Contract between the American and Licensee Companies attached to the Contract with the Postmaster General (Rec., *Missouri Case*, 130), and also in connection with the contract between the American Company and the plaintiff (hereinafter referred to as the *Missouri Company*). (Rec., *Missouri Case*, 322). In the Western Union Litigation (*infra*, 168), the Standard forms are used as the basis on which the accounting was sought and enforced (*Western Un. Tel. Co.* v. *American Bell Tel. Co.*, 187 Fed. 425, 449). Under Standard Form 113D (Appendix, 18) the toll licensee becomes obligated to assume the exchange license contracts then outstanding and those to be issued in Contract Form 109D (Appendix, 7). In the license contract to the American Company covering long distance service, that company becomes obligated to assume the exchange contracts then outstanding and those to be issued thereafter in Contract Form 109D (R. VI, 1990).

tem, said compensation not to exceed 5 cents per message of less than five minutes' duration.

FORM 113D—CONTRACT FOR EXTRA-TERRITORIAL CONNECTING LINES.

Standard Form 113D, Contract for Extra-Territorial Connecting Lines was issued by the American Bell to licensees who might or might not be also the exchange licensees. This contract required the former licensees: (a) to assume the obligations to pay the exchange licensee the portion of the toll charges required, by the Exchange Contracts already issued and by those to be issued (which were to be in the form of Exchange Contract Form 109D) to be paid for the use of necessary exchange facilities in connection with extra-territorial connecting service; (b) to pay the American Bell a percentage of the gross toll charges, ranging from 15% to 25%; and (c) to establish toll rates on a prescribed basis which should be not less than certain specified minimum rates. For these payments the licensee was granted the right to

> "construct lines between exchanges in said territory and to use such lines for telephonic personal communication between a customer in one such exchange district and a customer in another such exchange district * * * but the lessee shall connect with each local exchange and do its business, so as far as the same can, in the opinion of the lessor, conveniently be so done, with the customers thereof through said exchange, unless the American Bell Telephone Company, or its successors, shall decide that the exchange fails to furnish proper facilities." (Appendix, 20.)

Where contract Form 113D was issued to a company holding contract Form 109D for exchanges, it could render an exchange service, a local toll service and connecting company service, and/or a connecting company toll service between its exchanges and those of its sub-licensees.

AMERICAN COMPANY CONTRACT FOR LONG DISTANCE SERVICE.

We have already noted the license contract of 1894 from the American Bell to the American Company covering long distance service (*supra*, 42). Like Contract Form 113D, it obligated the American Company (a) to assume to pay the exchange licensee the portion of the long distance charge required by the exchange contracts already issued and by those to be issued (which were to be issued in the form of Exchange Contract 109D), to be paid for the use of necessary exchange facilities in connection with long distance service; and (b) to pay the American Bell 15% of the long distance charges (R. VI, 1997). For these payments it was to have the right to connect exchange systems throughout the Bell System for the purpose of transmitting messages to persons at stations in the territories of the respective licensees (*supra*, 42).

(b) COMPARISON OF STANDARD ARRANGEMENT PRIOR TO 1918 WITH CHICAGO COMPANY ARRANGEMENT PRIOR TO 1918.

The standard arrangement, as well as the Chicago Company arrangement, contemplated that (1) extra-territorial connecting service of all classes between Exchange Systems should be given to persons at exchange stations and not at exchange offices; (2) the use in such extra-territorial connecting service of the local exchange plant and operating personnel in connection therewith was part of the facilities furnished by the exchange licensee for the use of which it was to receive a portion of the toll charge.

But the Chicago Company arrangement in effect in 1918 differed from the Standard Arrangement in the following essentials:

The Chicago Company as the holder, under one con-

tract, of the Exchange and extra-territorial Connecting Service licenses, could offer as its own complete service two services,—an exchange service and a local toll service. It could establish the charges for each service, and could apportion between them common expenses and losses. It also could readjust from time to time its share of the long distance charges according to the standard of division prescribed by Section 10 of the License Contract of 1881, and could determine for itself the reapportionment thereof between the exchange and toll services. Such basis of division assured that neither the Chicago Company nor its exchange or toll services would ever be required to absorb any cost of making available for use in long distance service all necessary facilities, including the necessary exchange facilities, so long as the long distance charges of the American Bell for business transacted in the territory of the Chicago Company were sufficient to or could be increased to reimburse to the two companies the joint cost of making available for the use of the long distance service all their respective necessary facilities.† The same standard of division also assured that the Chicago Company (and through it, the exchange and toll services) would participate in the profits of the long distance business even though they were more than the profits from either or both exchange or local toll services or from any apportionment of connecting company business. The reciprocal provisions of Section 10 by necessary implication required that the long distance rate structure would at all times cover at least the entire cost for the use in such service of each and every necessary part of the Exchange facilities of the Chicago Company.

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† The burden would be on the two companies to show that the long distance rates could not be further increased (*Re So. Cal. Tel. Co.*, P.U.R. 1925 C, 627; *So. Bell Tel. & Tel. Co.* v. *R. R. Com. of Georgia*, 274 Fed. 438; Certiorari denied, 262 U. S. 761).

The Exchange Licensee operating under Standard Form 109D was treated as a separate unit or company. It could offer as its own complete service an exchange service only. For that service alone could it establish the charge. The exchange licensee could not control the establishment of or apportionment of charges of any class of extra-territorial connecting service making use of its Exchange facilities. The maximum portion of extra-territorial charge to be paid to it in each case was definitely fixed, without possibility of revision by it alone, no matter how great might be the loss to the exchange in making available in such service or services the necessary facilities and operating personnel in connection therewith. The exchange rates alone must absorb such loss from such service or services, no matter how profitable might be the extra-territorial service or services; nor could the exchange licensee ever participate in such extra-territorial profits. Even where the exchange and extra-territorial connecting line contracts were held by the same licensee, the exchange service was treated as a separate unit. The local toll, connecting line, and long distance rate structures absorbed a definite fixed expense as part of their respective charges for the use in their respective services of exchange facilities. This fixed expense did not vary, no matter how great might become the cost to the exchange licensee of making available its exchange facilities, and no matter how profitable might become the particular extra-territorial connecting service.

(c) OPPOSITE EFFECT OF IDENTICAL NEW ARRANGEMENT ON STANDARD EXCHANGE LICENSEE AND ON CHICAGO COMPANY.

From the comparison of the Chicago situation with that of Standard exchange licensee, it is certain that an opposite effect will be produced in their respective situations from

a new arrangement of the identical provisions of the 1919 Arrangement between each and the American Company.*

Concretely assume that in the standard situation the fixed portion of the long distance revenue payable to the Exchange licensee operating under perpetual contract Form 109D, was $100,000. Neither the obligation of the American Company nor the right of the Exchange licensee is decreased or increased by a declaration in a subsequent agreement that such payment is intended to be compensation for the use in the long distance service of all of the necessary exchange facilities, excepting the use of the local exchange plant and operating personnel in connection therewith (which latter use is covered by exchange rates). The fixed sum of $100,000 which the American Company was obligated to pay and which the exchange licensee agreed to accept by Contract Form 109D for the use of all necessary exchange facilities in fact used in long distance service, is precisely the same after as before the new arrangement. The fixed portion amounting to $100,000 is all that the parties ever agreed that the exchange licensee would receive, whether it in fact was sufficient to compensate for the use of all or of only a part of the necessary exchange facilities in fact used in the long distance service. To the extent that the fixed compensation did not yield adequate compensation for the use of all such necessary exchange facilities, to that extent must such deficit necessarily be covered by the exchange rates.

The new arrangement of the identical terms of the 1919 arrangement attains significance only if and when the Exchange licensee (or other proper authority) acquires the

* The Standard Revised License Contract, corresponding to and embodying the identical provisions as the 1919 Memorandum, is found in the Record of the Missouri Case, 262 U.S. 276. It appears as part of the contract between the American Company and the Postmaster General (Rec., *Missouri Case*, 130) and as the contract between the American Company and the Missouri Company (Rec., *Missouri Case*, 322).

right to demand that instead of the perpetual fixed compensation prescribed by the contract Form 109D, which has no relation to the cost of the rendering of service by the exchange, the exchange licensee be compensated on the basis of reimbursement of all expenses plus an adequate return on all necessary exchange facilities in fact used in the long distance service, including therein the local exchange plant and operating personnel in connection therewith. The new arrangement in the standard situation merely declares that if at any time the exchange licensee (or other proper authority) shall acquire such right to demand revision of the original standard long distance arrangement (which is reaffirmed), the exchange licensee will continue to cover by exchange rates the deficit to it from making available in the long distance service the necessary exchange facilities, to the extent of the full cost of the use in such service of the local exchange plant and operating personnel in connection therewith. With such a proviso in force, of course, the exercise of the right held by the exchange licensee (or other proper authority) to effect revision, even where the right exists, is held in abeyance so long as the payment previously made for the use of *all* necessary exchange facilities is still fair compensation for the use of the necessary exchange facilities *exclusive of* the use of the local exchange plant and operating personnel in connection therewith. Neither the fairness nor the legality of such proviso concerns us here.

But the significance of the new arrangement in the standard situation is entirely different from the significance of the same new arrangement embodied in the 1919 Memorandum with the Chicago Company. Thus, after February 1, 1919, the Chicago Company was forever precluded from including the use in the long distance service of the local exchange plant and operating personnel in connection therewith as part of its necessary facilities, for such use

of which necessary facilities the Chicago Company was entitled to a "reasonable and suitable division of the tolls and profits" of the long distance business transacted in Chicago, under Section 10 of the Original License Contract of 1881 (*supra*, 41). Before February 1, 1919, the Chicago Company had the right to insist at all times that the cost of the use in the long distance service of the local exchange plant and operating personnel in connection therewith be covered by its division of long distance receipts and profits. Its right of insistence was created by the Original License Contract itself, and did not depend on any right acquired (either by statute or otherwise) subsequent to the execution of the Original License Contract, as in the standard situation.

The issues in the two situations are entirely different. In the standard situation the burden is on the party questioning the payment to show (a) that the issue of the rejection of the new arrangement as an Act of Management is raised before the proper forum; (b) that facts exist sufficient to warrant the exercise of the right to revise the original agreement; and (c) what is the proper extent of the revision. To the degree that the proof of essential facts is lacking in definiteness or is offset by any of the other considerations which may influence a court of equity or commission in enforcing the revision, to that extent is the exercise of the right of revision likely to be defeated. In the instant case the burden of proof is reversed. Here the burden is on the party seeking to sustain the payment to show (a) that the statutory procedural requirements necessary to make the new arrangement effective have been or are being complied with; (b) that the new arrangement violates no statutory substantive law; and (c) that the new arrangement has already been approved as an Act of Management or is such as should be sanctioned. If the burden is not sustained as to all three requirements, the new ar-

rangement is illegally in force to the disadvantage of the Chicago Company (and through it to the disadvantage of the Chicago Local Exchange Service) and to the advantage of the American Company. To treat the long distance arrangement in Chicago on the same basis as the standard arrangement is to commit a fraud on the public in Chicago.

HOUSTON CASE (259 U. S. 318).

The ordinance of the City of Houston fixed maximum exchange telephone rates. The Southwestern Bell Telephone Company (hereinafter referred to as Southwestern Bell) at the hearing on its petition to the District Court to enjoin the City from enforcing such rates on the ground of confiscation, tested the confiscatory nature of the exchange rates on the basis of considering the revenues from all exchange business in relation to exchange property used therein. The company also offered, as its own complete service, a local toll service; it allocated to the Houston Exchange for the purpose of this suit, 25 per cent of the originating toll revenue, to cover the cost of making available for the local toll service the necessary exchange facilities. The City of Houston before the District Court, and, on appeal from the final decree before this Court, sought unsuccessfully to have the allocation increased to 60 per cent of the originating toll revenue on the ground that the smaller percentage was insufficient to absorb the cost of the use of all such necessary exchange facilities. The issue was therefore not what property the 25% allocation covered but whether the allocated compensation was sufficient. The report of the Special Master, confirmed by the District Court, found that "The only property belonging to the Houston Exchange used in handling a toll message is the equipment from the local subscriber's station to the long distance toll boards"

(Rec. Houston Case, Vol. I, 37). This Court in affirming the decree of the District Court held (259 U. S. 318, 322):

> "The company not only operated the Houston Local Exchange but it owned and operated long distance toll lines, connecting the local exchange with various towns and cities in Texas and several other states. The property used in the long distance service* which was not also used in the local service, was not included in valuing the investment for determining local rates, but, as the local lines were used to the extent of permitting a subscriber to connect from his home or office station with the long distance lines through the long distance station, the company, in practice, and for the purposes of this suit, credited the local exchange with 25% of the long distance toll revenues received from calls originating in Houston as compensation for the use made of the local plant in rendering long distance service."

This Court held the 25% allocation not unreasonable by comparison with the apportionments made of interconnecting service revenues between the Southwestern Bell and independent companies and with the allocations approved by State Utility Commissions throughout the country.

Several points of special significance have a bearing on the validity of the 1919 Arrangement in the instant case:

1. This Court was dealing with the years 1918-1919, the very years when the 1919 Memorandum was executed and made effective.

2. The allowance in the Houston case to the exchange revenues was clearly intended to cover the use in the local toll service of the local exchange plant and operating per-

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*The service designated in the Houston Case by this Court as "long distance" service is in this Brief designated as "extra-territorial connecting service" (*supra*, 36). "Long distance service" as herein used is confined to the extra-territorial connecting service offered by *the American Company* only (*supra*, 36). This Court was dealing in the Houston Case with that kind of extra-territorial connecting service called herein "local toll service," although it discussed other kinds as well (*supra*, 36).

sonnel in connection therewith. The 1919 Arrangement, which was sanctioned by the Statutory Court, expressly excluded any allowance from the long distance service for the use in that service of the Chicago local exchange plant and operating personnel in connection therewith, and is therefore contrary to the practice found to exist in the Houston Case.

3. This Court found that the practice of the South-Western Bell was the one customarily approved by State Commissions and adopted by exchange and extra-territorial service operators, where the two services were offered by separate companies (*Houston Case,* 259 U. S. 318, 322). Therefore, the 1919 Arrangement sanctioned by the Statutory Court is contrary to the approved general practice in the United States (where the two services are offered by two separate companies and where extraterritorial service is not the long distance service of the American Company).

4. This Court rejected the contention of the Southwestern Bell that the services rendered by the exchange to the extra-territorial service are only billing, collecting, and settling the toll account, plus the work of connecting the exchange switchboard with the toll switchboard (Southwestern Bell Brief, page 30). From the quotation given above (*supra,* 95), it is clear that this Court considered that the services of the exchange to the extra-territorial service were more than those represented by the Company's Brief; that is, *that the services of the exchange included also the use of the local exchange plant necessary to effect the connection of the exchange station with the toll switchboard.* An argument in support of the 1919 Arrangement that the local exchange plant is not *in fact used in the long distance service,* is, therefore, contrary to the holding of this Court (*Southern Bell Tel. & Tel. Co.* v. *R. R. Comm. of Georgia,* 274 Fed. 438, certiorari denied, 262 U. S. 761).

5. The 25% allowance which was approved in the Houston Case was for the use of the "local lines," and not for the use of the plant used exclusively in long distance service. Therefore, it cannot be argued that such allowance corresponds to the allowance of the 10% net return for the use of the long lines plant in Chicago (*supra*, 47).*

6. As bearing on the long distance arrangement between the Southwestern Bell and the American Company, it is sufficient to note here that the arrangement was embodied in Standard Exchange Contract 109D, which contemplated the use in the long distance service of the local exchange plant as part of the necessary exchange facilities for the use of all of which compensation was to come from the long distance service (*supra*, 85.) Contract 109D was cancelled in 1907 (Appendix, 39). The character of the long distance arrangement thereafter does not clearly appear. The long distance business transacted in the Houston Exchange was nominal. (Rec., Houston Case, Vol. II, 744).

Re: CHESAPEAKE & POTOMAC TELEPHONE COMPANY, P. U. R. 1926 E, 481, (Virginia); affirmed 147 Va. 43 (136 S. E. 575).

The Chesapeake & Potomac Telephone Company (hereinafter referred to as the Virginia Company) petitioned the Virginia State Corporation Commission to increase its exchange rates. The company offered, as its own complete service, exchange and intrastate local toll services, and also offered the long distance service of the American Company.

*It should be noted that the extra-territorial connecting service which became the local toll service was permitted by Standard Form 113D Contract for Extra-territorial Lines, issued by the American Bell in 1889 (Appendix, 18). That contract, of course, contemplated the use in the Extra-territorial Connecting service of the local exchange plant, the compensation for which use was to be covered by the allocated extra-territorial revenue (*supra*, 87). Although that contract was cancelled in 1907 (Appendix, 31), the rate structure developed on the basis of the early contract continued thereafter.

The Virginia Company made an allocation of property and expenses among exchange service, toll service, and long distance service* on the basis of covering by the exchange rates the use in the local toll and long distance services of the local exchange plant and operating personnel in connection therewith.

The Commission rejected these allocations, holding that as the local exchange plant and operating personnel in connection therewith were in fact used in the local toll and long distance services, as well as in the exchange services, the costs of the use of such plant and operating personnel by both of the extra-territorial services should have been allocated to them and between them (*Re Chesapeake & Potomac Tel. Co.*, P. U. R. 1926 E, 481, 627 (Virginia). The Order was affirmed by the Supreme Court of Virginia (147 Va. 43, 136 S. E. 575)).

The cases, therefore, are authority against the approval of any long distance arrangement of the character of the 1919 Arrangement by which the exchange rates are required to absorb the cost of use in the long distance service of the local exchange plant and operating personnel in connection therewith. The 1919 Arrangement is clearly against the general practice in the United States.

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*The Virginia Company derived its license through the Chesapeake & Potomac Company of New York, with whom the American Company entered into the Memorandum of 1920 embodying the original and revised long distance arrangements (*Re Chesapeake & Potomac Tel. Co.*, P. U. R. 1926 E, 481, 589). This Memorandum on its face shows that the Virginia Company had been operating under Exchange Contract Form 109D, issued May 23, 1882, and Extra-territorial Connecting Line Contract, Form 113D, issued February 7, 1885 (*Re Chesapeake & Potomac Tel. Co.*, P. U. R. 1920 F, 417 (Maryland)). The revision of this original standard long distance arrangement in the Memorandum of 1920 contained the identical language used in the 1919 Memorandum to cover the long distance arrangement with the Chicago Company.

D (8)

The sanction by the Statutory Court of the failure of the Chicago Company to properly separate from the costs of the Chicago exchange service the costs, measured on a proper basis, of the use in the long distance service of the Chicago Local Exchange Plant and operating personnel in connection therewith, was contrary to law.

The Statutory Court determined the issue of confiscation upon the basis of three tests: (1) upon a consideration of the entire Chicago business; (2) upon a consideration of the entire Chicago intrastate business only; and (3) upon the basis of the Chicago Exchange business only. In this section we consider only the first two tests, the third test being considered *infra*, 135.

For the first test it considered the entire Chicago local exchange plant and all expenses in connection therewith as part of the property and expenses of the Chicago service, and held that the additional income to the Chicago revenues necessary to offset the burden on the Chicago service of the cost of the use in long distance service of the local exchange plant and operating personnel in connection therewith, even if the 1919 Arrangement was illegal, would not be sufficient in amount to affect the result in the case. For the second test, it concluded that the Chicago Company, by making available to the long distance service the Chicago local exchange plant and operating personnel in connection therewith, was engaged in interstate commerce, but it held that the exclusion under the rules prescribed in the Minnesota Rate Cases of a portion of the Chicago local exchange plant and operating expenses incurred in connection therewith and attributable to the long distance service, would not affect the result in the case (R. I, 185). Both conclusions as to the negligible effect on the Chicago service of the use

in the long distance service of the Chicago local exchange plant and operating personnel in connection therewith were reached by comparing the relative amount of use in that service and in the Chicago exchange service of such plant and operating personnel, upon the basis of the relative number of local exchange calls and of originating long distance calls made in Chicago in 1923.

Error of Statutory Court.

The City contends that the Statutory Court erred because:

1. The estimate by the Chicago Company and by the Statutory Court of the cost of the use in long distance service of the local exchange plant and operating personnel in connection therewith, determined by the employment, as the measure of such use, of the number of originating long distance calls, without consideration of the number of such calls received in Chicago and without consideration of the amount of property used per call or of operating labor per call, is contrary to law.

2. The fact that the City did not present affirmative evidence to show the exact amount of Chicago exchange property and expenses used in the long distance service cannot *per se* lead to the legal sanction of the failure by the Chicago Company to exclude from the costs of the Chicago exchange service the costs of use in the long distance service of the Chicago local exchange plant and operating personnel in connection therewith, and to the legal sanction of its estimate of the cost of such use determined by the employment, as the measure of such use, of the number of originating long distance calls.

Discussion.

1. THE ESTIMATE BY THE CHICAGO COMPANY AND BY THE STATUTORY COURT OF THE COST OF THE USE IN LONG DISTANCE SERVICE OF THE LOCAL EXCHANGE PLANT AND OPERATING PERSONNEL IN CONNECTION THEREWITH, BY THE EMPLOYMENT AS THE MEASURE OF SUCH USE OF THE NUMBER OF ORIGINATING LONG DISTANCE CALLS, WITHOUT CONSIDERATION ALSO OF THE NUMBER OF SUCH CALLS RECEIVED IN CHICAGO AND WTHOUT CONSIDERATION OF THE AMOUNT OF PROPERTY USED PER CALL OR OF OPERATING LABOR PER CALL, IS CONTRARY TO LAW.

To constitute a proper showing of the amount of property used and expenses incurred in one of two services using joint property and incurring common expenses, the method of apportionment of property and expenses must bear a reasonable relation to the realities of the situation (*Minnesota Rate Cases*, 230 U. S. 352.) The determination of the amount of property actually used in the proper apportionment of expenses incurred in the two services is defective if made on any basis which assumes that the amount of property used and expenses incurred bear the same relation in both services to the unit of measurement employed as the basis of comparison between such services, when in fact the relation of property and expenses therein may differ (*Missouri Rate Cases*, 230 U. S. 474; *Minnesota Rate Cases*, 230 U. S. 352.) Before a particular unit of measurement can properly be employed as the basis of comparison between two services, there must be evidence to justify the conclusion that the relation of the amount of property used and of expenses incurred to the unit of measurement is the same in both cases of service, or if there is a material difference, there must be evidence to show its nature and the extent of such variation (*Wood* v. *Vandalia R. Co.*, 231 U. S. 1). The fundamental error of the Statutory Court lies in its assumption that the local exchange calls and originating long distance calls are comparable; that the amount of

use of property per call is the same in both services and that the expenses in relation to calls in both classes of service are the same.

The following considerations demonstrate conclusively that both assumptions are contrary to the facts as known to the Chicago Company and have been repudiated by the authorities:

1. Every local exchange call originated at one station in Chicago automatically becomes a corresponding call received at another station in Chicago. But a long distance call originated in Chicago never becomes a long distance call received in Chicago. Presumably there are as many long distance calls received in Chicago as are originated therein. It is, therefore, necessary to double the number of originating long distance calls in order to reduce the number of calls in both services to a comparable basis (*City of Kansas City* v. *Kansas City Telephone Co.*, P. U. R. 1922 A, 466 (Missouri)).

2. The unit call of the Chicago exchange service has as its maximum duration five minutes (R. IV, 1219). The Chicago Exchange rates are established on the basis of the number of such unit calls (R. VI, 2134, Exhibit A). The increase in duration of local exchange calls beyond the initial period leads to an increase in the number of calls chargeable to the subscriber. In the long distance service, however, the increase in duration of time of conversation beyond the initial period leads only to an increase in charge for the one call. Long distance rates are established on the basis of the initial period and overtime period and initial rates and overtime rates, the overtime rate for each additional minute or fraction thereof of overtime period being one-third of the entire initial period rate (R. VI, 2320).*

*This basis of rate making is used in the establishment of all extra-territorial rates between Exchanges (other than suburban rates) (*Re Rates and Charges of Telephone Companies*, P. U. R. 1920B, 411 (Arizona)).

Unless, therefore, the character of the local exchange calls is analyzed to determine how many of such numbered calls were created by overtime use, the comparison of the number of calls in the two services is illusory; nor does the record contain any data from which such analysis may be made.

3. Every local exchange call is a station-to-station call, i. e., a call to a specified station without the specifying of any particular person for conversation. But not every long distance call is a station-to-station call. Long distance service is classified (I) by the conditions limiting the completion of the order as specified by the calling party, and (II) by the time of the day or night when the conversation takes place.

I. The various demands of the calling party for classes of long distance service which differ in the conditions stipulated by the user as those under which the completion of the message is desired or required, may be expressed in four general classes; (a) a demand for messages where the calling party desires to talk to anyone at called station (station-to-station); (b) a demand for messages where the calling party desires a specified person or persons at a specified exchange or toll station (person-to-person); (c) a demand for messages where the calling party desires a specified person or persons only at a specified time (appointment); and (d) a demand for messages where the calling party desires only a specified person or persons, which can be met only by utilizing the services of a messenger (R. VI, 2321).*

*The Chicago Company has such four classes of calls in its own local toll service (R. IV, 1273). Such classes of calls are generally established for all extra-territorial connecting services (*Public Service Com.* v. *Mountain States Tel. & Tel. Co.*, P. U. R. 1924 C., 545, 615 (Montana); *Re Rates and Charges of Telephone Companies*, P. U. R. 1920 B, 411 (Arizona); *Re New England Tel. & Tel. Co.*, P. U. R. 1926 B, 247, 288 (Maine)).

II. Long distance service as represented by station-to-station calls is also classified by the hour of the day or night when the conversation takes place. From this standpoint, station-to-station calls are classified to come under Day Rate Schedules, Evening Rate Schedules, and Night Rate Schedules, dependent upon the particular time of the conversation.

The Statutory Court in using the ratio of the number of calls in long distance and local exchange service as the comparative measure of use in such services of joint facilities, erroneously assumes that the quantity of service rendered by the Chicago exchange plant and the operating personnel in connection therewith to furnish each of the four classes of long distance calls is the same; that the quantity of service rendered by the Chicago exchange plant and personnel to furnish station-to-station calls in long distance service is the same throughout the twenty-four-hour period; that the quantity of service rendered by the Chicago exchange plant and personnel to furnish a local exchange call is the same as that rendered to furnish a station-to-station long distance call.

The following facts show the wide variation in charge to the public for the use of the four classes of long distance calls. The station-to-station day rate between two points is about twice the station-to-station evening rate and four times the station-to-station night rate between the same points. A person-to-person call between the same points at any time during the twenty-four hours is about five times the station-to-station night rate, two and one-half times the station-to-station evening rate and one and one-quarter times the station-to-station day rate between the same points. Appointment call rates are about 20% greater than the corresponding person-to-person call rates, and are one and one-half times the corresponding station-to-station day rates, three times the station-to-station evening rates, and

six times the station-to-station night rates between the same points. Messenger call rates are the same as those for appointment calls, plus a charge for messenger service. The report charge (where the person-to-person, appointment, or messenger calls are not completed) is approximately the same as the station-to-station night rate for completed calls (R. VI, 2321). The variation in rates between the three sub-classes of station-to-station long distance calls on the one hand, and between station-to-station and the other classes of long distance calls on the other hand, is in each case based upon conditions peculiar to the classification, which conditions also have peculiar effect on the operation of the Chicago exchange plant and operating personnel used in connection with such calls, for which use of plant and operating personnel the Chicago Company receives no compensation from the American Company under the 1919 Arrangement. These conditions are:

(a) The increases in charge to the public for the person-to-person, appointment and messenger calls over the charge for station-to-station calls, obviously bear relation to the increase in operating costs necessary to handle such former classes of calls, particularly in the work done before the conversation commences. The station-to-station call does not include the additional burden to the Chicago exchange facilities arising from the holding of the subscriber's line and the facilities necessary to a person-to-person call during the time interval required to have the desired person come to the telephone. (*Re New England Tel. & Tel. Co.*, P. U. R. 1926 B, 247, 288 (Maine); *Re Rates and Charges of Telephone companies*, P. U. R. 1920 B, 411, 441 (Arizona); *Public Service Com.* v. *Mountain States Tel. & Tel. Co.*, P. U. R. 1924 C, 545, 615 (Montana)). The Chicago Company receives no compensation for the use of its exchange plant and operating personnel in connection therewith during the holding time, while the American

Company is compensated for the additional holding time of its own facilities, where the call is completed, and by the report charge where the call is not completed. (R. VI, 2321). As the report charge is considered in compiling the 12¢ originating commission to the Chicago Company (R. VI. 1975), no part of that commission admittedly is intended to cover the use in the long distance service of the local exchange plant and the operating personnel in connection therewith. The station-to-station call does not include the additional burden to the Chicago exchange facilities used in the appointment and messenger service calls of making two connections for one conversation, one in arranging for the appointment or messenger and one for the actual conversation between specified persons. The Chicago Company receives no compensation for the use of its local exchange plant and the operating personnel in connection therewith necessary to establish either of these two connections, while the American Company receives additional compensation to cover the additional use of its facilities, through the increased charge of the conversation if completed and the report charge of the conversation if incompleted (R. VI 2320-1). The employment of the number of calls as the measure of use does not give effect to these factors. It is a well-known fact that the number of station-to-station calls decreases in proportion to the length of distance of communication and the number of the more expensive classes of calls increases. The Statutory Court's application of the number of calls as the measure of use erroneously disregards the difference in the quantity of service rendered in the different classes of long distance calls, disregards the extent to which the service is affected by the development by one type of traffic as against the other, and as erroneously allocates to each class of calls only the quantity of service rendered in the class of calls requiring the least amount of service.

(b) As is well known, long distance business is confined mostly to the business or working hours of the day, and the plant is largely idle the greater part of the evening and night (R. VII, 2428 (22-34)). Since the amount of plant required obviously depends on the amount of traffic carried, the amount of long distance plant to be provided by the American Company is determined by the peak load during the day. To the extent that traffic is diverted from the period of the peak business, to that extent is there a saving in the amount of plant investment on which a return must be earned. To the extent that evening and night traffic is increased by the inducement of lower rates, to that extent is there created additional gross revenue which, after deduction of the operating expense of handling the traffic, becomes available to absorb the fixed carrying charges on the otherwise idle plant. Congress recognized the difference in the conditions of operation by sanctioning the establishment of day and night rate schedules. (41 Stat. at L. 474, Ch. 91, Sec. 400, par. 5.)

Due to two factors, a diametrically opposite effect, however, is created by such increase of long distance traffic on the Chicago exchange plant and operating personnel in connection therewith: (1) The Chicago Company, for its own complete service, can adjust the number of operators in accordance with the amount of traffic handled and can therefore reduce the number of exchange operators required during the off-peak period of evening and night exchange service. The American Company through the reduced evening and night rates increases in those same periods long distance traffic requiring the use also of exchange operators. This increased traffic, therefore, adds additional expense to the exchange service, for which no reimbursement whatsoever is given by the American Company; (2) since the number of operators required varies with the volume of traffic during the off-peak period,

the fewer operators who are required must each handle a larger section of the switchboard, which condition reduces their efficiency and in turn increases the cost of handling each call, as compared to the cost of handling the same call during the day. These facts are brought out in great detail in Traffic Circular 117, used by the Chicago Company in its current operations and in its estimate of Going Value, and introduced by the City as an Exhibit in the instant case (R. VI, 2285). To the extent that the American Company increases the number of calls handled by the exchange operators during the off-peak period, to that extent is the cost per call to the Chicago Company abnormally increased without any reimbursement thereof to the Chicago Company. The employment of the number of calls as the measure of use does not give effect to these two factors.

(c) The employment of the number of calls as a measure of use assumes that the same quantity of service is rendered by the Chicago local exchange plant and the operating personnel in connection therewith in furnishing station-to-station long distance calls as is rendered in a local exchange call. There is nothing in the record which warrants such assumption in view of the fact that the two classes of service are of an entirely different nature, involving in such difference the following well known factors: (1) the holding of the subscriber's line and facilities while the record of the long distance call is made by the long distance operator, a record which is not necessary for local exchange service; (2) either the holding of the subscriber's line and facilities while the long distance circuit is being built up or a second use of the subscriber's line and facilities when the long distance operator completes the circuit and connects the subscriber and listener for personal conversation. There is no comparable holding time for such purpose in local exchange service; (3) the natural desire

to make use of the entire initial period of conversation in a long distance call for which the initial rate has been charged because of the expensive nature of long distance service as compared to the inexpensive initial charge for local exchange calls. This factor necessarily leads to a longer average time interval of conversation in long distance service than in local exchange service, with a corresponding increased average use of exchange plant and operating personnel in the former service; and (4) the fact that the maximum limit of holding time for any one local exchange call is five minutes, but, that there is no limit to the maximum holding time for a long distance call (*supra,* 102).

With the average charge per long distance call in 1923 of $2.24 (*infra,* 120), compared to the charge for exchange calls of 5¢ per message, more than mere assumption is necessary to convince one that the cost of operation of any part of the facilities used in both services is the same or on a comparable basis. Yet the Statutory Court made such assumption in its computations, without reason therefor and without the existence of facts in the record to show the limits of the variation in such costs.

(d) The employment of the call as the measure of use is contrary to the measure of use which the Chicago Company represented would be required to determine the cost to it of making available for long distance service the Chicago local exchange plant and operating personnel in connection therewith. Its engineer who made and presented the various separations on its behalf and as part of its case, was asked by the City on cross-examination how he would proceed to determine the cost to the Chicago Company of making available to the long distance service the use of the local exchange plant and operating personnel in connection therewith. The method which he described was predicated

upon the employment, as the measure of use of property and of operating service in connection therewith, of an equated unit call, which takes into account not only the number of long distance and exchange calls but also the amount of property used per call and the amount of operating labor per call of each class of service, as follows:

> "I assume that what you want to know is how I would proceed to get at the cost to the Company of that part of the service which is embraced in the transmission of a long distance message from my station to the toll board. I would start out first by gathering considerable data to show the amount of use, the exact use of the subscriber station. The amount of exact use of the pair of wires leading from the station to the local switchboard, based upon holding times per message, comparing that with the holding times of the toll messages, and from that getting the ratio which I could apply a unit cost per station to the unit cost for the subscriber's line. When I get into the central office, our central office equipment is designed on the basis of calls and traffic units. By that I mean that for each class of calls handled by an operator, that call has a certain weighting. I would equate calls going from toll boards, allowing to those the proper co-efficients, and from that determine the number of positions or fractions of positions required to handle that service.
>
> I would then put that in the terms of cost, using our standard costs. That covers the switchboard end of it. Now, for the operating end, we would use those same units, applied to the cost per thousand units, for the handling of the service." (R. II, 850, 851.)

Although this engineer had never made such a study for the separation of the local exchange plant and expenses between the long distance and Chicago exchange services, (R. II, 851), he used the above method as a basis of separating other portions of the Chicago property used in more than one service, as presented in the instant case (R. II, 829, 830).

(e) The employment of the number of long distance calls as the sole measure of use of the property and operating

personnel has been rejected as unfair by the overwhelming weight of the authorities: (*Re: Southern Cal. Tel Co.*, P. U. R. 1925 C, 627, (California); *Re: Mo. & Kan. Tel Co.*, P. U. R. 1918 C, 55, (Kansas); *Re: Chesapeake & Potomac Tel. Co.*, P. U. R. 1926 E, 481, (Virginia); *Re: New England Tel. & Tel. Co.*, P. U. R. 1926 B, 247 (Maine); *Re: New England Tel. & Tel. Co.*, P. U. R. 1926 E, 186, 234, 249 (New Hampshire); *Re: Michigan State Tel. Co.*, P. U. R. 1923 A, 30, 114, 116 (Michigan); *City of Kansas City* v. *Kansas City Tel. Co.*, P. U. R. 1922 A, 466 (Missouri); *Re: Necedah Tel. Co.*, P. U. R. 1918 B, 888, 894, (Wisconsin)).

As the measure of use employed by the Statutory Court to determine the amount of property and expenses to be covered by the revenues complained of is unreasonable and contrary to law, the tests of the adequacy of such revenues predicated thereon must fail.

2. THE FACT THAT THE CITY DID NOT PRESENT AFFIRMATIVE EVIDENCE TO SHOW THE EXACT AMOUNT OF CHICAGO EXCHANGE PROPERTY AND EXPENSES USED IN THE LONG DISTANCE SERVICE CANNOT PER SE LEAD TO THE LEGAL SANCTION OF THE FAILURE BY THE CHICAGO COMPANY TO EXCLUDE FROM THE COSTS OF THE CHICAGO EXCHANGE SERVICE THE COSTS OF USE IN THE LONG DISTANCE SERVICE OF THE CHICAGO LOCAL EXCHANGE PLANT AND OPERATING PERSONNEL IN CONNECTION THEREWITH, AND TO THE LEGAL SANCTION OF ITS ESTIMATE OF THE COST OF SUCH USE DETERMINED BY THE EMPLOYMENT, AS THE MEASURE OF SUCH USE, OF THE NUMBER OF ORIGINATING LONG DISTANCE CALLS.

The approval by the Statutory Court of the failure by the Chicago Company to make any separation of the costs of use in the long distance service of the Chicago local exchange plant and operating personnel and the approval of its estimate of the amount thereof, was based partly on the

fact that the City did not present affirmative evidence showing the exact amount of such cost. The Statutory Court relied on the authority of *Rowland* v. *St. L. & S. F. Co.*, 244 U. S. 106; *Grossbeck* v. *Duluth S. S. & A. Ry. Co.*, 250 U. S. 607, and of four lower Federal Court decisions (R. I, 185). The Statutory Court erred because:

(a) The Statutory Court itself (R. I, 186) and each of the reviewing authorities in the cases cited by it, concluded that the approved plan of separation in each of the cases is legal and reasonable. Insofar as the approved plan in the instant case contained no separation whatsoever of the costs of use in the long distance service of the Chicago Exchange plant and operating personnel in connection therewith, the approval by the Statutory Court must be based either on the assumption that the 1919 arrangement is legal or that there is no use in fact in the long distance service of such plant and expenses. The first assumption is contrary to law (*supra,* 57, 61, 63, 75) and the second is contrary to the facts (*supra,* 35). Insofar as the plan of separation contained a separation of the costs of the use in the long distance service of the Chicago exchange plant and operating personnel in connection therewith, on the basis of the measuring of such use by the number of originating long distance calls, the approval thereof by the Statutory Court must be on the assumption that it is reasonable to employ as the measure of use, the number of originating long distance calls, without consideration of the number of long distance calls received in Chicago, the amount of property used per call, and the amount of labor per call. Such assumption, we have just proved, is contrary to fact and has been rejected by the authorities. Therefore the illegality and unreasonableness of the plan presented by the Chicago Company destroys the necessary assumption required as a condition precedent to the application to the instant case of the principle established by the authorities

cited by the Statutory Court, and destroys the necessary assumption required for the proper conclusion as to the legal effect of the negative attitude of the City.

(b) The Statutory Court failed to distinguish between the issues of the approval of a plan of separation which itself is legal and reasonable but which is opposed as not being the most reasonable or as being subject to inaccuracies, and of a plan which, as in the instant case, is opposed as being illegal and arbitrary. In the latter situation, neither the negative attitude of the opposing party in failing to present a legal or reasonable method, or in failing to present affirmative evidence of the result of a legal and reasonable method (*Chesapeake & Potomac Tel. Co. of Virginia* v. *Commonwealth of Virginia,* 147 Va. 43, 136 S. E. 575, P. U. R. 1926 E, 481), nor even the approval by all parties of the illegal and arbitrary method presented by the party on whom the burden rests to make a proper separation, can supply to the latter the legality and reasonableness necessary as a condition precedent to its legal sanction (*Missouri Rate Cases,* 230 U. S. 474, 497).

(c) **The Statutory Court overlooked the special facts in the instant case which make it unfair to attach any significance to the failure by the City to undertake the separation upon a proper basis and which make it unfair not to attach special significance to the failure by the Chicago Company itself so to do.** At no time prior to or since the effective date of the 1919 Arrangement has the Chicago Company itself made a study to determine the cost to it and to the Chicago exchange service of making available to the long distance service the use of the Chicago local exchange plant and operating personnel in connection therewith (R. II, 848). Although the Order of August 16, 1923, attacked herein, erroneously assumes that payment by the American Company for the use of the balance of the Ex-

change facilities excluding the local exchange plant and operating personnel, was in fact intended to cover the use of all exchange facilities including such plant and personnel, the Order disapproved the amount of such payment. As the Commission found "that there are not sufficient facts in this record to permit of making a proper adjustment" (R. I, 39), it stated that "The Commission believes that this matter should be fully investigated and an equitable adjustment made to the end that a greater part of the toll charges be paid to the Illinois Bell Telephone Company" (R. I, 188). No separation of its property was made by the Chicago Company before the Commission (R. I, 184). The Bill of Complaint contained a separation of intrastate and interstate property, revenues, and exepnses. But nothing contained therein revealed the basis on which the separation was made or revealed that the separation was made on any improper basis (R. I, 2). The Chicago Company procured its temporary injunction on affidavits on December 21, 1923 (R. I, 178), which injunction was confirmed by this Court on October 19, 1925 (R. I, 178). The record before this Court shows that on the hearings on the preliminary injunction the City opposed the method of separation because of the failure of the Chicago Company to demand compensation for use in long distance service of the local exchange plant and operating personnel in connection therewith (Record, 345, *Smith* v. *Ill. Bell Tel. Co.*, 269 U. S. 531). Its motion for judgment on the *pleadings was denied* July 11, 1927 (R. I, 171). Certainly from this latter date the Chicago Company knew that the case would be heard on final hearing on the evidence. The hearings in fact commenced on April 15, 1929 (R. I, 179). Yet during all this time the Chicago Company itself made no study of such cost by the method which its own engineer said was the proper one to use.

At the final hearings the Chicago Company made known

the basis on which the separation to be presented by it had been made, and desired the City to agree thereto (R. II, 815, 816). Had the City done so, its agreement could not have given any legal sanction thereto (*Missouri Rate Cases*, 230 U. S. 474, 497). At the beginning of the final hearings the City made known its position that the determination of the costs of the use in long distance service of the Chicago local exchange plant and operating personnel in connection therewith was necessary because of the illegality of the 1919 Arrangement (R. II, 820) [illegible] out to the Chicago Company this its own proper method of determining such cost [illegible] Nevertheless the Chicago Company persisted in its position that the 1919 Arrangement was legal and that in any event its effect was negligible. This latter conclusion is based on the proposition that the determination of cost of the use of the local exchange plant in the long distance service could be determined by comparing the number of originating long distance calls with the number of local exchange calls. Such method was in conflict with the one pointed out by its own engineer as the proper method and which is quoted, *supra*.

On this record *it is difficult to understand the process of reasoning by which the Statutory Court seeks to penalize the City for not supplying the evidence which the Chicago Company was required to furnish to support its burden of proof*, but which it refused to do. The instant situation is in marked contrast to the cases wherein a utility whose plan of separation was approved, had spent much time and effort at a large expense to procure the result of a legal and reasonable method of measuring use and of separating property, the details of which were submitted to the opposing party, which criticised but offered no substitute therefor.

The excuse by the Chicago Company that a proper determination would entail an expense chargeable to the Chi-

cago local exchange service (R. II, 851), is clearly untenable for two reasons. In the first place a party having the burden to prove a proper separation cannot justify an improper one either because of the difficulty of study of the expense thereof where the data available therefor is in the control of the untility and sufficient data can be procured by using typical test periods (*Missouri Rate Cases*, 230 U. S. 474, 497). In the second place, under Section 10 of the Original License Contract of 1881 the expense of accounting complicated items of the joint long distance enterprise would become a common expense to be shared by the Chicago and American Companies (R. VI, 1929).

It is therefore an imposition on the City representing the Chicago local exchange subscribers and on the subscribers themselves, to require them to stand the entire accounting expense or to suffer the consequence of having no proper accounting whatsoever between the two companies. On the record it is clear and just that special legal consequences should attach to the failure by the Chicago Company to make the necessary accounting for a proper separation; but that no special consequences attach to the failure by the City to undertake the accounting on behalf of the Chicago Company is clearly wrong. The failure of the Statutory Court to recognize such facts was error.

* * * * * * * *

Before discussing the legal consequences of this failure by the Chicago Company to make showing as to the use of its local exchange plant, as herein discussed, we will take up its failure to make a similar showing as to the use of other of its facilities necessary in the long distance service.

DISCUSSION AS TO CONTENTION NUMBERED II.

II.

THE DISTRIBUTION DID NOT EVEN REIMBURSE THE CHICAGO COMPANY FOR THE COST OF MAKING AVAILABLE TO LONG DISTANCE SERVICE THE NECESSARY FACILITIES IN CHICAGO OTHER THAN ITS LOCAL EXCHANGE PLANT AND OPERATING PERSONNEL IN CONNECTION THEREWITH.

A.

The compensation for the use of the balance of the necessary exchange facilities, excepting the use of the local exchange plant and operating personnel in connection therewith, and for the use of the toll trunks, is arbitrary and grossly inadequate.*

The exchange facilities necessary to the long distance service (excepting the local exchange plant and operating personnel in connection therewith) include the service by the Chicago Company of billing, collecting, and settling the accounts, the service of its making available its own customers as potential customers for long distance service at subscribers' stations and the service of its making accessible subscribers' and public pay stations for long distance service to non-customers of the Chicago Company (*supra* 50-1). Settlement for such latter service in 1923 was on the basis of 12¢ per message originating at subscribers' and public pay stations (R. II, 787). There is nothing in the record to indicate how the 12¢ charge had been estab-

*The compensation covering the use of the described exchange facilities and of the toll trunks is commonly known as the "originating commission."

lished or to indicate that a study had ever been made to determine the basis upon which adequate compensation should be established or to determine the adequacy of the 12¢ charge itself (R. II, 786). Apparently the Chicago Company has continued to accept since 1919, as the basis of compensation for the use of its necessary exchange facilities *excepting* the use of its local exchange plant and operating personnel in connection therewith, the same basis of compensation as that established in 1899 for the use of such facilities *including* the use of such plant and operating personnel in connection therewith (R. II, 841). It is inconceivable that any specific charge made in 1899 to cover any services of the Chicago Company suitable to conditions existing at that time could be applicable as a basis of charge in 1923 for such service or any part thereof. Nor is the 12¢ arrangement in accordance with the provisions of the 1919 Arrangement covering the basis of charge to Bell licensees for making available to the long distance service those exchange facilities intended to be covered by the 12¢ charge (*supra*, 52). No explanation has been made of why the 1919 Arrangement should be effective to cover the use in the long distance service of the local exchange plant and operating personnel in connection therewith but should not be effective to cover the use in that service of the balance of the necessary exchange facilities. If written contracts are to be treated so lightly, it is difficult to see how any effective regulation of the public utility functions of the Chicago Company can be undertaken.

The basis of charge for the use of toll trunks was established in 1911 at 5¢ per paid originating long distance message, which basis has never been changed. No study had ever been made since 1910 to determine the cost of making them available to the long distance service (R. II, 841). There is nothing in the record to show the amount of investment in the toll trunks in 1923 or at any other date.

The failure of the Chicago Company to make any study covering these items is in violent contrast to, and is inexcusable in the face of, the numerous studies which it has made to determine the fairness of distribution of tolls between it and connecting companies (R. IV, 1328), between it and associated companies (R. IV, 1334-41), and between its own local toll and exchange services (R. II, 786), and the numerous studies it has made to determine the cost to the American Company of maintenance of long lines plant (R. VI, 1948, 1957, 1961).

Both the cost of service and the charge to the public for person-to-person, appointment and messenger calls in long distance service are increased above the cost of and charge to the public for the station-to-station class of long distance calls (*supra*, 105). The Chicago Company bears the varying increased cost of service for such classes of calls in the use for them of its trunks and necessary exchange facilities, but receives only the same 17¢ compensation for its services in all classes of long distance calls. Both the cost of service and the charge to the public are increased in all classes of long distance service where the time per call exceeds the initial period on which the rate is established. The Chicago Company, as to its trunks and necessary exchange facilities, bears the same increased cost of service but receives no increase in the 17¢ compensation. Both the cost of service and charge to the public are increased where there is an increase in cost of labor and material. There were several increases in the long distance rates of the American Company from 1912 to 1923 (R. I, 39). The Chicago Company, as to its trunks and necessary exchange facilities, bears the increased cost of service, but receives no increase in the 17¢ compensation.

The resulting imposition on the Chicago Company through the increase of the cost to it of making available its necessary exchange facilities and toll trunks, but the lack

of increase in its compensation, is apparent from the following comparisons:

The average long distance charge per originating call in 1913 was $1.43 and in 1923, $2.24.* The per cent of increase of average toll per long distance call from 1913 to 1923 was 57.3%. The originating commission in 1913 was 17¢ and in 1923 was 17¢. The per cent of increase in the originating commission from 1913 to 1923 was 0%. To the extent that the 57.3% increase in the long distance average charge represents (a) overtime consumed in conversation, (b) increase in the number of calls of classes other than station-to-station calls, and (c) increase in rates per call—to that extent has the cost of the rendering of service by the Chicago Company increased from 1913 to 1923. If the 17¢ charge was reasonable in 1913, these facts show conclusively that the charge could not possibly be reasonable in 1923.

The 17¢ commission received by the Chicago Company is based only on the outgoing business, although the same service is rendered also to incoming business. The revenue received by the American Company for long distance business in Chicago is on incoming and outgoing messages. Section 10 of the Original License Contract of 1881 requires a distribution which takes into account both classes of revenues (R. VI, 1929). The burden of loss to the Chicago Company due to the unfairness of the 17¢ arrangement of 1923 is therefore doubled.

Illusory Comparison with the Arrangement between the Chicago Company and connecting companies.

The Statutory Court found the 17¢ arrangement fair,

*In 1913 the number of originating long distance calls was 671,194; the gross long distance business originating in Chicago was $959,754.74 (R., VI, 1980). In 1923 the number of originating long distance calls was 1,997,886; the gross long distance business originating in Chicago was $4,490,167.89 (R. VI, 1980). The ratio of the 17c commission to gross tolls in 1913 was 11.9 per cent; in 1923, 8.1 per cent.

holding that it was a greater commission than that paid by the Chicago Company to the 293 independent telephone companies (R. I, 187).

Settlements in 1923 between the Chicago Company and the 293 independent telephone companies in Illinois for business interchanged between them was on the basis of the payment to each company of an originating commission and a prorate of the balance of the toll charge. The originating commission was intended to cover the use in the connecting company service of all necessary exchange facilities of each company, including the use of the local exchange plant and operating personnel in connection therewith. The basis on which the originating commission was established was a percentage of the entire toll charge, including overtime charge on originating calls where the initial period charge was less than 75¢. The percentage of commission varied with the variation in the toll charge for the initial period, from 60% of the initial period charge of 10¢ or under to 25% of the initial period charge of 25¢ to 75¢ inclusive. On all messages where the initial period charge was over 75¢ the originating commission was established at 6¢ per every paid minute of conversation (R. IV, 1362). This compensation was to be reduced 50% if the Chicago Company took over the operation of the toll board (R. IV, 1362).

The originating commission paid in the long distance service to the Chicago Company and the originating commission paid by it in the connecting company service represents in each case a gross payment which must cover the cost of the service rendered intended to be covered by such payment. It is obvious that no comparison is possible between originating commissions paid in two services unless the cost of rendering the respective services intended to be covered by each commission is the same in both cases or unless the variation of cost between them has been defined

(*Minnesota Rate Cases*, 230 U. S. 352; *Missouri Rate Cases*, 230 U. S. 474; *Wood* v. *Vandalia R. Co.*, 231 U. S. 1). To label a payment to an originating company as an "originating commission" neither connotes or denotes the quantity of service or the specific property or expense intended to be covered by it. The 17¢ arrangement in the long distance service bears no relation to the amount of toll charge established for the initial period of communication of any class of long distance call, or to the amount of property used per call for the varying classes of calls, or to the time consumed per call (*supra*, 102-3). The originating commission paid by the Chicago Company to connecting companies in 1923 bore relation to each and all of such factors. The arrangements of the Chicago Company with the connecting companies contemplated in each case that the originating commission should cover the use in the extra-territorial service of the local exchange plant and operating personnel in connection therewith which, of course, was not true in the case of the 17¢ arrangement. In the arrangements with the connecting companies the balance of the toll charge, after deduction of the originating commission, was divided between the Chicago Company and the connecting companies; the Chicago Company received the greater percentage of such balance* (R. IV, 1362). Under such circumstances, the smaller the originating commission, the greater was the share of the balance of the toll distributed to the Chicago Company. The opposite was true in the case of long distance service. The balance of the long distance revenue, after deduction of the originating commission, all remained with the Amer-

*The Chicago Company had the right to extend its own toll lines as far as possible in transmitting the toll messages, even to the exchange office of the connecting company and even though the connecting company itself also owned toll lines. This would give the Chicago Company the greater portion or all of the toll revenue on messages originated in its territory, and the greater portion or all of the balance of the toll revenue after deduction of the originating commission where the message originated in the territory of the connecting company. (R. IV, 1351, 1364.)

ican Company excepting specified payments to the Chicago Company for the use of the long lines plant in Chicago, which payments bore no relation to the amount of gross tolls received. Under such circumstances the American Company and not the Chicago Company benefited from a small originating commission. The distance of travel of a connecting company call is small; the shorter the haul the greater the number of station-to-station calls and the less the cost of service to be covered by the originating commission. The reverse is true of the long distance service.

It is strange that the Statutory Court could have determined that there was any possible comparison on the present record between the gross originating commissions paid in the long distance and in the connecting company services of the Chicago Company. The present record shows conclusively that the 17¢ arrangement is arbitrary and does not afford to the Chicago Company adequate compensation for the services intended to be covered by it.

B.

The return to the Chicago Company on its investment in long lines plant is 40% lower than the return which it considered a fair return on the investment of property leased by it from the American Company.

We have already noted that the Chicago Company was to receive as rent for the use of the long lines plant a net rental of 10% of the average monthly book cost of plant (*supra*, 47). This basis of rental is subject to the following adjustment:

1. At least since May 20, 1915, the Chicago Company has agreed to absorb the City tax in the 10% net return paid it by the American Company (R. VI, 1945). In 1923 the City franchise tax of 3% on the revenue received from the

American Company amounted to .93%, leaving in fact only 9.07% net return on average book cost to the Chicago Company (R. IV, 1275).

2. The annual net rental which the Chicago Company calculated as fair for the rental use by it of the telephone instruments owned by the American Company represented in 1923 a yield to the latter of 11.3% on the reproduction cost of the property before deduction of depreciation (*infra*, 219). But the yield to the Chicago Company from the rent of the long lines plant calculated on a comparable basis of reproduction cost, as estimated by the Chicago Company, before deduction of depreciation, is less than 6%. There is no reason why the Chicago Company should receive a lower net annual return in 1923 (calculated on a comparable basis) from the American Company for the use by the latter of property owned by the Chicago Company. Either the rental received by the Chicago Company is 40% too low or the rental paid by the Chicago Company is 90% too high.

This inequality does not give effect to the fact that both the equipment, aggregating a large percentage of the long lines property, and the telephone instruments, are manufactured by the Western Electric. The American Company, as the owner of 99% of the stock of the Western Electric, is the beneficiary of the profits on both items of property (R. VI, 2283). Due to this factor the inequality of treatment is increased.

C.

In addition to receiving no compensation for the use in the long distance service of its local exchange plant and operating personnel in connection therewith, the Chicago Company receives no compensation for the use of other necessary facilities made available to that service.

The Chicago Company estimated that there was no profit remaining in 1923 from the 17¢ commission (R. V, 1787). The total net profit from the long distance distribution to the Chicago Company was represented by the compensation for the use of the long lines plant and for supervision and operation of the long lines plant and aggregated $325,102 (*supra*, 30).

The Chicago Company contended and the Statutory Court found that the distribution was fair and reasonable, by relating this net return of $325,102 to average book cost of long lines plant (R. I, 187). By so doing the Chicago Company and the Statutory Court made no provision for any compensation whatsoever to the Chicago Company for the use by the American Company of the following facilities [in addition to its use without its paying compensation, of the local exchange plant and operating personnel in connection therewith]:

1. The advertising expenses from 1921 to 1925 averaged $102,000 per year (R. I, 251). The Order of August 16, 1923, found that this expense included the cost of advertising the long distance business, which advertising benefited that service, but for the cost of which the American Company made no reimbursement whatsoever (R. I, 41, 42). The Chicago Company also advertised in its directories the long distance business (R. VI, 2319, 2322), and the Bell System as an institution (R. VI, 2323, 2324, 2325, 2326). The entire

expenses of publication were paid by the Chicago Company without any contribution by the American Company (R. V, 1862). As the American Company apportions among the associated companies its costs of advertising the long distance business (*Re New York Telephone Co.*, P. U. R. 1923 B 545 (New York)), there is no reason why the Chicago Company should not charge it for such advertising.

2. The same considerations which lead to the existence of Going Value of the Chicago Company in its complete services lead also to the existence of Going Value of the Chicago Company in its handling of the long distance service. The same items of cost of training employees and of attaching new exchange service as benefit its local service automatically benefit its operations in the long distance service. The company estimated this item of Going Value at $21,750,000 (R. II, 715). The Commission and Statutory Court allowed $4,196,872 for Going Value as an item of property for rate making purposes. No separation has ever been made on the basis of use (determined by a proper measure) of the portion of Going Value allocable to long distance service. It is estimated that 60% of Going Value is used jointly in the two services. If Going Value exists at all, certainly the American Company should contribute a return thereon.

3. Similarly an estimate is made that 60% of the $3,000,000 working capital of the Chicago Company is used jointly in the complete services of the Chicago Company and in the long distance service (R. V, 1744). No separation has been made on the basis of use (determined by a proper measure of use) of the portion of working capital allocable to long distance service. As working capital is necessary for all operations of the Chicago Company, including the long distance service, certainly the American Company should contribute a return thereon.

DISCUSSION AS TO CONTENTION NUMBERED III.

III.

THE BASIS ON WHICH THE DISTRIBUTION WAS MADE ADMITTEDLY DID NOT AND COULD NOT TAKE INTO ACCOUNT THE PROFITS OF THE LONG DISTANCE BUSINESS TRANSACTED IN CHICAGO.

As already noted, the "reasonable and suitable division" prescribed by Section 10 of the Original License Contract of 1881 (R. VI, 1929) was to be of the tolls and *profits* of the long distance business. This provision assured to the Chicago Company a participation in such profits, if any, after provision was made for the amount required to pay the respective operating expenses, taxes, and a fair return on the respective properties of the two companies held for and used in the long distance service from which the revenue was derived. In the determination of the amount of such participation, this provision assured to the Chicago Company that due consideration would be given to any fact or circumstance which would ordinarily, without regard to the investments, entitle it to a greater proportion than the American Company.*

*Section 15, (6) of the Interstate Commerce Act provides for such consideration by the Interstate Commerce Commission whenever it is called upon to make a division of joint rates between several carriers (U. S. C. Title 49, Sec. 15, (6)).

A.

The method of settlement in the long distance service does not take into account the three special factors for which the Chicago Company is entitled to compensation from the profits of the long distance business.

1. During the full period of long distance conversation, the long distance operator and the user have the exclusive control both of the facilities of the Chicago Company used exclusively in long distance service and of its facilities used jointly in that service and in the services of the Chicago Company. During such period, the 1919 Arrangement deprives the Chicago Company of the use for its own complete services of such jointly used facilities. This deprivation results, no matter how urgent may be the need of the Chicago Company for the immediate use of such facilities nor how limited the surplus facilities beyond its own requirements (R. VII, 2465 (42)). As the measure of local exchange service is the number of messages of limited time duration (*supra,* 102) while the measure of long distance service is the number of messages of unlimited time duration (*supra,* 102), it is obvious that the Chicago Company, in making available to the increased long distance service its facilities used both in its own services and in the long distance service, not only contributes the capital and operating service which the American Company uses, but also either contributes a loss to itself, through the decreased use of its equipment for other services, or else contributes an increased investment through the necessity of increasing its facilities to care for the same amount of use in its own services.

2. The long distance service requires a higher standard of maintenance of plant than local exchange service. As every exchange line is a long distance line and every ex-

change station is the center for that station of the entire Bell System (R. VII, 2524 [43]), the standard of the long distance service determines the standard of maintenance of the entire exchange plant used in all services. The American Company so admitted:

> "Limited local service can be given by a plant that would be useless in a comprehensive system made up of local exchange and toll, and particularly in connection with long distance service. Although 90% of the connections are purely local, the 10% that are not local are more important * * * and must be equally available through one station equipment. For that reason the Bell plant must be maintained at a higher standard than would be necessary if it were a purely local exchange service." (R. VII, 2499 (6)).

The settlement on the basis of the comparative use of the facilities throws the burden of the increased cost of maintenance onto the services of the Chicago Company other than the long distance service. It also throws onto these other services the obligation to provide an adequate return on the extra investment not only currently made, but placed in the plant in previous years.

3. The Chicago facilities are the originating and delivering terminals; the American Company's facilities, the intermediate lines. The Original License Contract of 1881 gave to the American Company a non-exclusive right to use the Chicago facilities for long distance communication. Under that same contract, the Chicago Company also had the right, without requiring the consent of the American Company, to connect its own lines with those of other Bell licensees, which right permitted it to offer a connecting company service originating in the territory of either company (R. VI, 1927). The standard licensee had no such right. (Appendix, 7, 18). The 1919 Arrangement took away from the Chicago Company its unlimited right so to connect and in lieu thereof requires it to procure the

consent of the American Company to make any such connections. The extra advantage to the American Company and the disadvantage to the Chicago Company from this revision is evident from an inspection of the telephone maps for the years 1922-1923 (R. VII, 2630, 2631, 2642). They show the strategic position of the Chicago Company as the center of the territory of those licensee companies of the Bell System which have the densest toll line development. As evidence of the value to the Chicago Company of this strategic position, note the very favorable arrangement which it has with those licensees with whom it does connect (R. VII, 2630). The 1919 Arrangement gives to the American Company the full and exclusive benefit of the advantageous position of the Chicago Company without its paying the Chicago Company any compensation therefor.

B.

The method of settlement with the Chicago Company destroys the benefit to it of Section 10 of the Original License Contract of 1881 and revokes the long distance arrangement between the parties.

1. By fixing the compensation to the Chicago Company on the basis of a fixed amount per message (the 17¢ originating compensation), and on the basis of a fixed return on property (long lines arrangement), the American Company retains 100 per cent of all profits in excess of the net return allowed to the Chicago Company from such compensation, and the Chicago Company stands 100 per cent of the losses if the cost of making available its necessary facilities exceeds the compensation allocated to it therefor. In order that any settlement to the Chicago Company on the basis of such fixed compensation shall still be in conformity with the standard prescribed by Section 10, the

amount or per cent of fixed compensation must be continually readjusted to assure that it is not unjust, unreasonable, inequitable, or unduly preferential or prejudicial as between the two companies.* The American Company can provide reimbursement through increased long distance rates to absorb all payments to the Chicago Company as well as any other increased costs, so long as the increased long distance rates are not prohibitive. Several such increases were in fact made between 1913 and 1923. (R. I, 39). In the same period, the Chicago Company also increased its rates for local exchange service to absorb increased costs. (R. I, 39). But during the same period, the parties made no study to ascertain the adequacy of the fixed bases of compensation to the Chicago Company from the long distance service, and to readjust the same to absorb the increasing cost to the Chicago Company of rendering its service to and for the American Company. (R. II, 841.)

2. The basis of settlement between the parties in the long distance service is in violent contrast to the basis of compensation between them for the use by the Chicago Company of the telephone instruments leased and services rendered by the American Company under the so-called 4½% arrangement prescribed by the same 1919 Memorandum, which established the basis of compensation for the use of necessary exchange facilities in long distance service (*infra*, 142, 201). The compensation to the American Company is on the basis of a percentage of the gross operating revenue of the Chicago Company, including its share of the long distance revenue. This basis of compensation gives

*Section 15, (6) of the Interstate Commerce Act gives to the Interstate Commerce Commission jurisdiction to readjust divisions of joint rates between carriers (but not between telephone companies) upon its own initiative or upon complaint to avoid the result discussed in the text (U. S. C. Title 49, Sec. 15, (6)). The Illinois Public Utilities Act apparently gives no such jurisdiction to the Illinois Commerce Commission as to division of joint telephone rates established prior to 1914 (Illinois Laws, 1913, Sec. 42, 481.

to the American Company a participation in any increase in the Chicago Company's rates and a participation in the increase in average revenue per station, even though such increases leave no increase in net return to the Chicago Company and even though the cost to the American Company of rendering the service intended to be covered by the compensation has not increased. The basis of settlement to the Chicago Company in the long distance service likewise gives to the American Company 100 per cent of the additional revenue coming from any increase in rates or increase in average charge per message due to increase in time consumed or to increase in the number of calls of the more expensive classes of long distance calls.

The preferential treatment of the American Company through the method of settlement between the parties for their reciprocal services is disclosed by the following comparisons: From 1913 to 1923 the distribution to the Chicago Exchange Service decreased from 11.9% of the long distance tolls received by the American Company from business in Chicago, to 8.1% of such toll, a decrease of 32% (R. VI, 1980). On the other hand there was no decrease in the per cent of the local exchange revenue paid to the American Company. To the extent that such decrease of 32% was due to increased revenue to the American Company from (a) increase in rates, or (b) increase in average per message due to increase in time consumed or in the number of calls of the more expensive classes of long distance calls, to that extent is undue prejudice created against the Chicago Company and against the community served by its Chicago local exchange service.

DISCUSSION AS TO CONTENTION NUMBERED IV.

IV.

THE FAILURE OF THE CHICAGO COMPANY TO SHOW THAT IT HAD RECEIVED A "REASONABLE AND SUITABLE DIVISION OF THE TOLLS AND PROFITS" OF THE LONG DISTANCE BUSINESS TRANSACTED IN CHICAGO HAS DESTROYED THE POSSIBILITY OF DETERMINING THE LEGAL INADEQUACY OF THE CHICAGO EXCHANGE RATES.

A.

There is no possible standard by which the fairness of the distribution can be determined from the facts appearing in the record.

1. The total gross long distance tolls in Chicago in 1923 were $8,980,000. The total distribution to the Chicago Company of $2,023,209 (R. VI, 1980; IV, 1571) represents 22.52% thereof. The Statutory Court held the distribution fair because it represented from 45% to 49% of the gross originating tolls (R. I, 187). The distribution to the Chicago Company covers the services on calls received in its territory as well as on calls originating therein. Assuming that on the calls received in Chicago the distribution from the revenues therefrom to the company in whose territory they originate equals the distribution to the Chicago Company (an assumption most favorable to the American Company), there still remains in the treasury of the American Company 54.84% of gross tolls or $4,823,632 unaccounted for and available for maintenance and return on the American Company's intermediate long distance plant (the heavy originating and terminal expenses all having been deducted).

There is no possible way of determining from the record what percentage of gross tolls is absorbed in the operation of the American Company's own long lines plant. Without such data, there is no more reason to assume that the net return to the American Company from its 54.84% of gross revenue represents a small or fair net return than there is to assume that the greater portion of such gross distribution represents also the net distribution from such business. There is no possible basis of determining the fairness of the distribution by comparing the relation of its amount to the total revenue with that of the amount retained by the American Company.

2. The Statutory Court by relating the compensation of $325,102 paid for the operation and use of the Chicago long distance plant to the average investment therein, held that the net return thereon was fair by comparison with the net returns represented by the Chicago Company to have been received from the operation and use of the entire Chicago investment. (R. I, 187). This comparison assumes that the $325,102 represents the net income after deduction of all expenses and charges of operation of all property in Chicago used in the long distance service—an assumption which is not true (*supra*, 35). It assumes that the 17-cent originating commission has provided the net return on the toll trunks—an assumption for which there is no basis of fact in the record (*supra*, 120). It assumes that the property in Chicago used in the long distance service other than the toll trunks, consists only of the long lines plant,—an assumption which is not true (*supra*, 35).

It assumes that the net revenues of its Chicago business in fact received by the Chicago Company are as shown by it—an assumption not true for three reasons: 1. The Statutory Court itself added back $2,160,000 to the net revenues as shown by the Chicago Company (R. I, 197).

2. The expenses included the cost of use in the long distance service of the local operating personnel and in the maintenance of the local exchange plant used in that same service for which the Chicago Company received no offsetting revenues from the long distance service. 3. The expenses include the cost of use in the local toll service of the local operating personnel and the cost of maintenance of the local exchange plant used in that service. We have already noted that in 1923 the local toll rates covered the use in that service of the Chicago local exchange plant and operating personnel in connection therewith (*supra*, 69). The separation of the plant in Chicago used in local toll service and the operating expenses in connection therewith, from that used in the local exchange service, was on the basis of considering all the exchange plant and all operating expenses in connection therewith to be covered solely by local exchange rates (R. II, 846, 847). By such consideration, the expenses of the Exchange Service are made to include illegally a part of the expenses of the local toll service for which the Chicago Exchange service received no offsetting revenues from the local toll service.

The comparison of the Statutory Court assumes that the Chicago investment to which the Chicago net revenues are related includes only the property to which such net revenues are applicable. This is not true for two reasons: 1. The Chicago investment includes the portion of the local exchange plant used in the long distance service for which no offsetting compensation is paid by the American Company. 2. The Chicago investment includes also a part of the Chicago exchange plant used in the local toll service but for the use of which the Chicago Exchange receives no offsetting revenues from such local toll revenues. Until the expenses incurred and property used in extraterritorial and long distance services are excluded from the Exchange plant and expenses, and those portions

thereof applicable to the long distance service are included in the expenses and property to be covered by the distribution to the Chicago Company from the long distance service, no comparison between the net revenues from the two services is possible.

Before the fairness of the distribution from the long distance tolls and profits can be determined at least the following essential items of property and expense must be measured, the data for which measurement is not in the record:

I. Reimbursement of the actual cost of use plus a fair return on the value for rate making purposes of a per cent (calculated on proper basis of use) of local exchange property used by the Chicago Company to connect customers of the American Company, who may or may not be customers of the Chicago Company, at the subscribers' and public pay stations to the toll switchboards and to the toll trunks for long distance communication (*supra*, 35)...Amount unknown

Estimated amount of physical Chicago local exchange property (excluding working capital, material and supplies, work in progress, and going value) used partially in this service, upon the basis of book costs on June 30, 1923 (R. I, 126) 60% of.....$95,626,014

Upon the basis of the Chicago Company's estimate of reproduction cost new as of June 30, 1923 (after deducting 10% depreciation as allowed by the Statutory Court), (R. IV, 1155), 60% of $130,723,510

Upon the basis of the Commission's valuation as of June 30, 1923 (after deducting 10% depreciation), (R. I, 195), 60% of $108,442,193

Upon the basis of the Statutory Court's valuation as of June 30, 1923 (after deducting 10% depreciation), (R. I, 195), 60% of $117,450,000

II. A per cent of working capital (calculated on a proper basis of use).....Amount unknown

Estimated amount of working capital used partially in the service—60% of (R. V, 1742) ..... $ 3,000,000

III. A per cent of items making up Going Value in 1923 (calculated on a proper basis of use) .....Amount unknown

Estimated amount of Going Value used partially in the service on the amount estimated by the Chicago Company (R. V, 1742), 60% of $21,750,000

Upon the allowance by the Commission and by the Statutory Court's allowance—60% of....$ 4,196,872

IV. Amount to take care of additional benefits to the American Company through services of the Chicago Company in advertising the American Company and the long distance business (*supra*, 125) .....Amount unknown

V. The difference between the arbitrary 5¢ per paid message compensation paid and the actual costs of use plus a fair return on the value for rate making purposes of a per cent (calculated on proper basis of use) of the toll trunks used to connect central offices and toll switchboards (*supra*, 118) .....Amount unknown

VI. Difference between the arbitrary compensation of 12¢ per originating long distance call and the actual costs of use plus a fair return on the value for rate making purposes of a per cent (calculated on proper basis of use) of the necessary exchange facilities other than the local exchange plant and operating personnel in connection therewith (*supra*, 117)..Amount unknown

VII. Reimbursement of extra cost to the Chicago Company of operating, and a fair return on the additional investment in exchange property, due to the higher standard of efficiency required for long distance service than for exchange service (*supra*, 128) .....Amount unknown

VIII. Total net profit from long distance business transacted in Chicago from which the Chicago Company is entitled to receive a just share as an originating and terminating company enjoying a strategic position in the Bell System (*supra*, 129) .....Amount unknown

B.

The additional net income to the Chicago revenues from the long distance service necessary to offset the burden on the Chicago service imposed by the illegal inclusion, as part of its cost of operation, of the cost of the use in the long distance service of the Chicago facilities, and for the use of which facilities no compensation whatever, or inadequate compensation, is paid by the long distance service; or the value of property which is used, and the expenses which are incurred in the long distance service and not deducted from the Chicago property and expenses, but which should be deducted under the rule established in the Minnesota Rate Cases, is in either case sufficient in amount to affect the result in this case.

The Statutory Court found that the net income available for return in 1923, after deducting the $1,700,000 reduction under the rates prescribed by the Order of August 16, 1923, was $6,740,000 or a yield of 5.39%. The Chicago Company's own showing under the rates in force in 1923, and still in force, revealing net income available for return before deducting $1,700,000, was $6,280,000, or a yield of 5.02% (R. I, 197). The Chicago Company's showing for the same year was no better than that of the Chicago exchange service (*infra*, 347, 348). The experience of the Chicago Company since 1923 shows that it has been able to attract capital on very favorable terms and has been able to maintain the stability of its securities on a high plane (*infra*, 348). There would, therefore, appear to be no question at all as to the adequacy of the rates complained of. But assuming that there is, the maximum difference between the rates complained of and those under which the Chicago Company has and is operating is $1,700,000, or 19.2 per cent of the gross long distance tolls of the

Chicago business in 1923 (R. VI, 1980). If such additional payment were made from such gross tolls, it would still leave to the American Company $3,123,632 or 35.64 per cent of the gross tolls unaccounted for and available for return on its own intermediate long lines plant.* There is nothing in the record to show what percentage of gross long distance tolls is necessary to give to the American Company an adequate return nor what in 1923 was its return from its long distance business, nor how far, if necessary, long distance rates can be increased as a practical matter, to permit adequate returns to all the companies joining in the rendition of the long distance service.

In the absence of a showing that such rates cannot be increased (*Re Southern Cal. Tel. Co.*, P. U. R. 1925 C, 627 (Cal.)), the Chicago Company is legally entitled to reimbursement of at least all of its costs of making available all of its necessary facilities under Section 10 of its Original License Contract of 1881 (R. VI, 1929). But it failed to present the necessary data from which the Commission could make a proper determination of the just distribution to the Chicago Company from the long distance service. In the light of such failure the Commission did the best it could to establish what it considered reasonable rates under all the circumstances. Under the law the Chicago Company was required to procure full reimbursement from the long distance service, as a condition precedent to asking for affirmative relief from the Statutory Court against the Order of August 16, 1923. The affirmative relief requested involved, at most, $1,700,000—a sum less than the amount

*As the standard arrangement between the American Company and the Bell licensees never gave to them the same right to the additional payment to cover the use by the American Company of their respective local exchange plants and operating personnel in connection therewith as the Chicago Company enjoyed under Section 10 of its Original License Contract of 1881 (R. VI, 1929), they would not be entitled to an equivalent additional payment. No further deduction is therefore made from the gross tolls to compensate any terminating licensee company.

available for reimbursement; a payment neither unreasonable nor prohibitive.*

For years the Chicago Company took no steps to procure the essential data, although it was advised by the Commission and by the City that the fairness of that distribution from the American Company was in controversy (*supra,* 113). Who but the Chicago Company is to blame for the necessary conclusion that its failure to supply such necessary data has made it impossible for any reviewing authority to say that the local exchange service and not the long distance service has failed to provide the minimum adequate return on its Chicago investment to which the Chicago Company is constitutionally entitled.

Similarly, under the law, the Chicago Company was required to show that the intrastate revenues were confiscatory. It failed to exclude any exchange property and expenses used in interstate commerce, although the City had raised the issue of the propriety thereof many years before the final hearings. The possible amount of deductible property and expenses, if determined upon a proper basis, might be sufficient to render the intrastate rates adequate. The exact amount of deductible property and expenses is unknown. Who but the Chicago Company is to blame for its failure to supply the necessary data?** It has failed to show that the intrastate revenues are inadequate (*Minnesota Rate Cases,* 230 U. S. 352).

*New York Tel. Co. v. Prendergast, 300 Fed. 822, is distinguishable on the ground that the increase in exchange and local toll revenues contended for by the complainant therein exceeded the total gross tolls from the long distance service. *Re New York Tel. Co.* P. U. R. 1923B, 545.

**In *Re Missouri & Kansas Tel. Co.* (P. U. R. 1918 C, 55 (Kansas) and in *Re Southern Cal. Tel. Co.* (P. U. R. 1925-C, 627 (California) attempts were made to show the effect on the exchange net revenues of covering by the extra-territorial revenues the cost of use therein of the local exchange plant and operating personnel in connection therewith. The heavy burden on the exchange service shown to exist in these cases is very significant. But the burden on the Chicago Exchange Service will necessarily be relatively greater, in view of the differences in the kind of extra-territorial service offered, in the size of the exchanges, and in their location—differences which increase the cost to the Chicago Company above the cost in such other cases. (*Re New York Tel. Co.* P. U. R. 1923-B 545, 637-8 (New York); *Re New England Tel. & Tel. Co.*, P. U. R. 1926-E, 186, 212 (New Hampshire)).

Chesapeake & Potomac Tel. Co. of Virginia v. Commonwealth of Virginia, 147 Va. 43, 136 S. E. 575, is particularly in point.

The Supreme Court of Virginia, on appeal by the Chesapeake & Potomac Telephone Company, a Bell licensee, reviewed the rates for the complete service of that company established by the Virginia State Corporation Commission. These rates were less than those which the company considered reasonable or adequate. The company failed to show any reimbursement to it for the use in the long distance service of its local exchange plant and operating personnel in connection therewith, but absorbed in the rates for its own complete service the entire cost of such use. The Commission and court found that the local company was entitled to reimbursement. *Re: Chesapeake & Potomac Tel. Co.*, P. U. R. 1926 E, 481; *Chesapeake & Potomac Tel. Co. of Virginia* v. *Commonwealth of Virginia*, 147 Va. 43, 136 S. E. 575.

No showing having been made of the amount thereof, the Commission established what it considered reasonable rates in the light of the available data.

The Supreme Court affirmed the Commission's order, holding that the company had failed to make the required showing that the services for which the rates complained of and not the long distance service had failed to provide the necessary return on the investment under investigation (pp. 76-79).

The instant situation is even stronger in requiring a dismissal of the Bill of Complaint filed herein than the situation covered by Virginia case in three respects: (1) The Chesapeake & Potomac Company was a standard licensee which did not have the assurance by contract of full reimbursement of all cost of use in the long distance of each and every part of its necessary facilities, as did the

Chicago Company (*supra*, 88). (2) In the Virginia case it did not appear, as it did appear in the instant case, that the company was receiving no compensation or inadequate compensation for the use in the long distance service of its facilities other than the local exchange plant and operating personnel. (3) The Chesapeake & Potomac Company was a standard licensee which did not have a right to participate in the profits of the long distance business as did the Chicago Company under Section 10 of the Original License Contract of 1881. The Statutory Court should have dismissed the bill.*

LICENSE PAYMENT TO AMERICAN COMPANY OF 4½% OF GROSS OPERATING EARNINGS.

The Chicago Company charged to operating expenses in 1923 an excessive charge of at least $1,015,243, included in the 4½% payment to the American Company.

The Chicago Company in 1923 charged $1,724,243 to operating expense, which sum represented its payment to the American Company of 4½% of the gross operating revenues of the Chicago Exchange, pursuant to an arrangement embodied in the Memorandum effective February 1, 1919, already discussed in connection with long distance service (*supra*, 49). The City contends that the charge is excessive by at least $1,015,243. The services intended to be covered by the charge as made are: (1) the rental of telephone instruments owned by the American Company in service in the Chicago Exchange; (2) the right to financial assistance; (3) the right to use inventions and improvements made by or through the American Company and embodied in manufactured apparatus; and (4) the right to

*In the section on "Domination and Control" (*infra*, 251) we discuss the effect on the long distance arrangement of the conclusion in that the Chicago Company is a mere department of the American Company. In the section on Rate of Return (*infra*, 366), we discuss the proper method of accounting for the use by the American Company of the Chicago facilities.

demand from the American Company services of business management incident to efficient ordinary operation of its local public utility functions in Chicago.

The Order of the Public Utilities Commission of Illinois of December 20, 1920, under which the Chicago Company has since 1920 collected exchange rates in Chicago (R. IV, 1281), disregarded the binding character of the Memorandum as a bilateral contract. It found that in addition to rental of instruments the Chicago Company received the license to use patented devices, the patents of which belonged to the American Company, together with engineering, financial and advisory service which were of great value to the Chicago Company (R. IV, 1301). It allowed and limited the annual average payment made to the American Company as an item of operating expense, to $2.10 per station for all services (R. IV, 1301). The Order of August 16, 1923, which is now being attacked, likewise disregarded the binding character of the Memorandum as a bilateral contract but upon the lack of any showing against the charge for the year 1922, held that it would not disturb the allowance per station prescribed by the previous Order (R. I, 40). The Statutory Court refused to pass on the binding character of the Memorandum as a bilateral contract, holding that the difference of $360,000 between the allowance made by the Order of August 16, 1923, and the payment required by the Memorandum, would not affect the result of the case. Its calculations included as an operating charge the sum of $1,364,000 calculated on the basis of the Commission's allowance. This amount is excessive by $655,000 (R. I, 191). The Chicago Company, however, charged to operating expense in 1923 and in each year since 1920 the full payment prescribed by the Memorandum. This amount is $1,015,243.*

*The charge to operating expense on a per station basis in 1921 was $2.60 (R. VI, 2083, 2084); in 1922, $2.52 (*Idem*); in 1923, $2.61 (R. III, 1044); in 1924, $2.61 (R. VI, 2083, 2084); in 1925, $2.61 (*Idem*).

ERROR OF STATUTORY COURT.

The fundamental error in treatment by the Commission and by the Statutory Court lies in this: In examining the service of the American Company covering the use of patents and of improved non-patented apparatus manufactured by the Western Electric they fail to take into account the Western Electric relationship to the American Company and the Western Electric relationship to the Chicago Company. The Western Electric is the exclusive manufacturer of the patented and non-patented devices (for which the American Company claims credit) under a contract with the latter, made in 1882 and still in force, whereby the Western Electric reimburses the American Company for all costs incurred by the latter and turns over to it, free of charge, the license to use the Western Electric patents which comprise 74% of all patents whose control the American Company claims (*infra,* 157). The Western Electric prices to the Chicago Company, therefore, absorb the entire cost of development of these patented and non-patented devices. Since 1908 the same devices have been made available to non-licensees by their purchase without any additional payments to the American Company (*infra,* 183). Obviously the two payments for the Wesern Electric merchandise by the Chicago Company must be compared to the single payment by the non-licensees. The Commission and the Statutory Court failed so to do. Similarly, in examining the Western Electric prices the Commission and the Statutory Court did not take into account the fact that the payment by the Chicago Company to the American Company includes royalties and compensation for developments incident to the use of the purchased apparatus.

In treating the financial service purported to be rendered by the American Company, they fail to recognize that the

financial service which the Chicago Company received was not the usual financial assistance given by the American Company to the balance of the Bell System in the form of loans at reduced rates of interest (*infra,* 189) and in purchasing stock at prices which such could not bring on the market. The only possible service for which the American Company was entitled to charge is the right to receive after 1918 the benefits of the plan of cooperative financing of the Bell System as a unit, under which the American Company pools the net assets and the net earnings of the entire system, including its own showing, to provide the capital for each part thereof (*infra,* 367). The only possible way in which the benefit of such financing service is reflected in the showing of the Chicago Company is in the fact that under this cooperative plan the standard of adequate net earnings required to be earned by each licensee from its own operations is the average net earnings on a comparable basis of the licensees as a whole. Such a standard of determining adequate returns is obviously a lower standard than that which would be required had each licensee functioned as an independent enterprise in procuring its own financing apart from its relationship in the Bell System. The Commission and the Statutory Court charge the Chicago Company for the declared right to receive a financial service which it did not receive, but do not take into account the true nature of the service rendered.

In measuring the benefits from the service of business management, the Commission and the Statutory Court fail to distinguish between the service of recommending the purchase of improved apparatus, which is the function of persons efficiently operating a utility, and the service of recommendations which are embodied in the Western Electric apparatus, and which are covered by the Western Elec-

tric prices to the Chicago Company. Had the Commission and the Statutory Court taken these factors into account, they would have found that:

SUMMARY STATEMENT OF CITY'S CONTENTIONS.

I. The charge to operating expense in 1923 of $1,724,243 on the basis of the binding force of the 1919 arrangement as a Bilateral Undertaking is in violation of law.

II. The maximum charge to operating expense in 1923 should be $709,000, represented by the charge allocated by the Chicago Company to cover the rental of the telephone instruments. The excessive charge to operating expense in 1923 was $1,015,243.

In support of its contention numbered (I) the City offers the following:

A. Prior to 1919 the Chicago Company had no right to demand and the American Company had no obligation to supply the three services of (1) financial assistance; (2) making available inventions and improvements embodied in manufactured apparatus; and (3) business management—in consideration of the payment by the Chicago Company of a percentage of its gross revenues.

B. The rights of the Chicago Company and the obligations of the American Company created and affirmed by the 1919 Arrangement are unenforcible.

C. The 1919 Arrangement is not such an act of management as should be sanctioned.

D. The compliance with the procedural requirements of the Public Utilities Act of Illinois necessary as a condition precedent to making the 1919 Arrangement legally effective was not made.

E. The 1919 Arrangement violates substantive law.

In support of its contention numbered II the City offers the following:

A. The payment of $709,000 allocated to rental of instruments is excessive by $120,000.

B. No financing service from the American Company was required by or was given to the Chicago Company in 1923 or at any time during the entire period of their relationship prior thereto or at any time thereafter during the period under investigation.

C. The service of making available inventions and improvements embodied in manufactured apparatus was covered in 1923 and since 1908 has been covered by the purchase price paid to the Western Electric for such apparatus.

D. The service of business management in 1923 was more than compensated for by the following payments made and benefits derived therefrom to the American Company:

(1) The sum of $120,000 improperly included in the charge for rental of telephone instruments.

(2) The eight special financial services rendered by the Chicago Company, without charge, to the American Company in 1923:

(a) The use of the credit of the Chicago Company to liquidate $13,800,000 long past due indebtedness owing from the Central Union to the American Company;

(b) The use of the Chicago Company's credit to permit the American Company to withdraw in cash more than the entire amount of its capital investment in the Central Union properties transferred to the Chicago Company, which capital investment prior thereto had been wiped out through losses in operation, and at the same time to permit the American Company to retain the same interest in the future earnings of such properties;

(c) The use of the credit of the Chicago Company to finance thereafter the Central Union prop-

erties conveyed to it, in lieu of the use of the credit of the American Company which theretofore for many years had been the sole credit used for that purpose;

(d) The payment to the Central Union (and through it to the American Company, the owner of 99% of its stock) of a profit of at least $3,700,000 included in the purchase price for the Central Union properties transferred to the Chicago Company, which properties had been operated at a loss for at least seven years prior thereto;

(e) The use, free of charge, of the entire operating local organization of the Chicago Company, as the local selling agency for the sale of the American Company's stock to the public and the use of the Chicago Company's facilities and of its accessibility to more than 600,000 local exchange customers for such stock selling operations in 1923;

(f) The use, free of charge, of the facilities of the Chicago Company in selling the American Company's stock to the employes of the former, and in collecting and remitting installment payments aggregating $1,500,000 in 1923;

(g) The profit to the American Company through filing consolidated income tax returns and charging the Chicago Company on the basis of a separate return;

(h) The profit to the American Company derived through the method of financing the Chicago Company by investing therein only in stock yielding 8%, as compared to the method of financing the balance of the Bell System on the basis of investing therein partly in stock yielding 8% and partly in credit obligations yielding 5.88%.

(3) The profit to the Western Electric (and through it to the American Company, as the owner of 99% of its stock) derived from the sale to the Chicago Company of apparatus recommended by the American Company as part of its service of business management.

DISCUSSION AS TO CONTENTION NUMBERED I.

I.

THE CHARGE TO OPERATING EXPENSE IN 1923 OF $1,724,243 ON THE BASIS OF THE BINDING FORCE OF THE 1919 ARRANGEMENT AS A BILATERAL UNDERTAKING IS IN VIOLATION OF LAW.

A.

Prior to 1919 the Chicago Company had no right to demand and the American Company had no obligation to supply the three services of (1) financial assistance; (2) making available inventions and improvements embodied in manufactured apparatus; and (3) business management—in consideration of the payment by the Chicago Company of a percentage of its gross revenues.

SUMMARY OF HISTORICAL SURVEY 1876-1919.

No intelligent discussion of the issues herein involved is possible without taking into account the history of the relationship between the American and the Chicago Companies prior to the 1919 Arrangement. We have herein presented, on pages 156 to 195, such an historical survey for the period 1876-1919, together with such other facts of general application throughout the Bell System as have a bearing on the issues discussed. This historical survey in summarized form discloses the following situation covering each of the services of the American Company:

1. *Financial Service.*

At no time prior to 1918 did the Chicago Company have the right to demand, or did the American Company have the obligation to supply, any financial service (*infra,* 167, 182, 183). Nor was the financial service at any time re-

quired by, nor was it given to, the Chicago Company (*infra*, 163, 185). On the contrary, the Chicago Company throughout this period rendered valuable financial service to the American Company without making any charge therefor (*infra*, 164, 185).

Such financial relationship was not the normal one in the Bell System. The other Bell licensees not only received very valuable financial assistance from the American Company in the form of loans, for which they were not required to pay commissions, and under circumstances when local financing was not possible, but the rate of interest charged to them was below the open market rates of interest and below the cost to the American Company of procuring funds during the period of such loans (*infra*, 189). This rebate in interest in 1918 in some cases exceeded the entire 4½% payment by the borrowing licensee (Central Union Telephone Company (*infra*, 191) and the Southwestern Bell Telephone Co.* the appellant before this Court in the Missouri Case, 262 U. S. 276 (hereafter referred to as the Missouri Company, *infra*, 192); in some cases it left either no balance whatsoever or only a small portion of the amount required to pay the fair annual rental for the use of telephone instruments alone (Michigan Telephone Company and Cleveland Telephone Company) (*infra*, 191); in still other cases it left a sum sufficient to take care of the rental for the telephone instruments, but left nothing or only a small amount available as compensation for the services of mak-

*In 1917 the Missouri & Kansas Telephone Company, a Missouri corporation, changed its name to Southwestern Bell Telephone Co. and acquired certain properties of the Southwestern Telegraph & Telephone Company, a Missouri corporation, (Rec. *Missouri Case* 148). The Southwestern Bell Telephone Company is the appellant in the *Missouri Case* (262 U. S. 176); the Southwestern Telephone & Telegraph Company a New York corporation (hereafter referred to as the Southwestern Bell) was the original plaintiff (Rec. *Houston Case*, Vol. I, 3). In 1920 the Southwestern Bell Telephone Company, the same company which was the appellant in the *Missouri Case*, purchased the properties of the plaintiff in the *Houston Case*, and became the substituted complainant in the court below and the appellee before this Court (Rec. *Houston Case*, Vol. II, 775; 259 U. S. 318).

ing available inventions and improvements embodied in manufactured apparatus, and of business management (Southwestern Bell, the appellee before this Court in the Houston Case, 259 U. S. 318 (*infra*, 192), and Wisconsin Telephone Company (*infra*, 191)).

2. *Service of Making Available Inventions and Improvements Embodied in Manufactured Apparatus.*

(a) *Patented Apparatus*:

From 1881 to 1919 the Chicago Company had the right to demand and the American Company had the obligation to supply apparatus, other than telephone instruments, manufactured under patents owned or controlled by the American Company, upon the payment by the Chicago Company of a royalty to be included in or to be in addition to the purchase price paid for the apparatus itself, as the American Company might direct (*infra*, 159). The cost and expense of inventions and improvements made by or through the American Company and embodied in patented apparatus manufactured by the Western Electric, were reimbursed by the latter under its Contract of 1882 with the American Company (*infra*, 157) and were absorbed in the purchase price paid to the Western Electric for such apparatus by Bell licensees, including the Chicago Company (*infra*, 157).

During this period no cash royalty, as such, for patented apparatus was in fact demanded from or was paid by the Chicago Company to the American Company (*infra*, 167). In lieu of such cash royalties, the American Company was compensated by (1) the increased instrument rental revenues through expanded telephone service resulting from the contributions of capital by the licensees for the growth of the telephone business (*infra*, 178, 180); (2) by increased profits to the Western Electric through increased pur-

clause

~~lense~~ of apparatus (*infra*, 166, 171, 179); and (3) by increased revenues from its own long distance service through the adaptation by the licensees of their plants to the requirements of extensive and intensive use thereof as the terminal facilities for the long distance service of the American Company (*infra*, 180). Since 1908 the patented apparatus of the American Company became available to and were compensated by non-licensee telephone companies in the price paid by them for such merchandise manufactured by the Western Electric, no royalty, as such, being paid thereon (*infra*, 184). Taking into account the provisions covering patented apparatus as contained in the Western Electric Contract of 1822 with the American Company, in the Western Electric Contracts with the Chicago Company and in the American Company's Original License Contract of 1881 with the Chicago Company, the maximum royalty, as such, which the American Company could legally exact from the Chicago Company in 1918 and thereafter is represented by the difference between the price paid by the Chicago Company and that paid by non-licensee companies of the Bell System to the Western Electric for the same apparatus.

outside

(b) *Non-Patented Apparatus.*

From 1881 to 1919 the Chicago Company had no right to demand and the American Company had no obligation to supply improvements in non-patented apparatus. The same conclusions follow respecting the situation after 1908 *in re* improvements in non-patented apparatus as is stated above as to patented apparatus.

(c) *Telephone Instruments.*

From 1881 to 1919 the Chicago Company had the right to demand and the American Company had the obligation to supply the use of telephone instruments manufactured un-

der patents owned or controlled by the American Company upon the payment by the Chicago Company of a yearly cash royalty and rental (*infra*, 159).

In 1902 such cash rental and royalty was established on the basis of a yearly charge of 4½% of the gross operating revenues of the Chicago Company. Beginning with 1908 the same telephone instruments leased to the Chicago Company became available to non-licensee telephone companies by purchase from the Western Electric without the payment by them of any royalty to the American Company. Taking into account the provisions covering the telephone instruments as contained in the American Company's Manufacturing Contract of 1882 with the Western Electric, in the Western Electric Contracts with the Chicago Company, and in the American Company's Original License Contract of 1881 with the Chicago Company, the maximum cash rental and royalty which the American Company could legally exact from the Chicago Company in 1918 and thereafter was limited by reasonable annual charges to be based upon the market price to non-licensee telephone companies of the telephone instruments.

3. *Service of Business Management.*

From 1881 to 1919 the Chicago Company had no right to demand and the American Company had no obligation to supply the service of business management covering the operations of the Chicago Company (*infra*, 167, 176). In 1883 the American Company owned $19,000,000 par amount of stock in subsidiary companies, on which it was receiving an average yearly cash dividend of 1.3% as against 40% cash dividends on its stockholdings in the Chicago Company. The American Company's stockholdings in the Chicago Company represented 1.3% of its stockholdings in the licensee companies and produced 22.7% of all cash dividends received by it (*infra*, 165). The total cash divi-

dends received by the American Company in 1883 represented only 25% of its cash royalties on telephone instruments (*infra*, 166). In 1883 the American Company established, and thereafter to 1896 developed, an organization to coordinate the results of the operations of the Bell licensees, as disclosed in their reports required to be made from time to time, and offered to them and encouraged them to solicit, advice and assistance in business management—all for the purpose of improving the earning power of these stocks and of making them its principal source of income when the patents on telephone instruments expired. By 1896 this purpose was accomplished; cash dividends exceeded the total cash royalties (*infra*, 166). From 1896 to 1908 the American Company, as the operator of the long distance service, and the Bell licensee companies, made available as the terminal facilities for the long distance service the plants and operating personnel of the latter and dominated the field of telephone communication by providing more extensive facilities, better service, and better relations to the public. They, likewise, perfected apparatus and improved methods of operation (*infra*, 177). By 1908 the Bell System was dominant in the field (*infra*, 181).

In 1908 the American Company began, and by 1918 completed, the reorganization of the license companies including the Chicago Company to operate them as departments of the Bell System, which then functioned as a single operating unit, with the American Company as the responsible head. This single unit offered an efficient nationwide unified telephone service without limitation of property ownership or of legal restraints in the administration of the affairs of the Bell licensees incident to their separate and distinct corporate existence (*infra*, 193). As part of this reorganization, the American Company relieved the licensee companies, including the Chicago Company, of the necessity of maintaining any organization other than for

operating. In lieu thereof it substituted its own service of business management, employing the central organization which it had built up in the past in the manner and for the reasons above stated, and the accumulated data acquired by it through its association with the Bell licensee companies during the period of their past relationship.

Beginning with 1907 the American Company began the revision of the standard Original Bell License contracts including that with the Southwestern Bell by which revision each licensee was made to contribute to the maintenance and expenses of the management service transferred to and assumed by the American Company, which management service the latter obligated itself thereafter to supply. A percentage of gross revenue of each such licensee theretofore used to fix the cash rental or royalty for the use of telephone instruments, was adopted as the perpetual charge for such use, which percentage of gross revenue included, also, the perpetual contribution of the licensee to said maintenance and expenses of the centralized management service, of the services of financial assistance, of making available inventions and improvements embodied in manufactured apparatus (*infra*, 175). The surplus over and above the actual costs and expenses of such services was to remain in the treasury of the American Company for the benefit of the Bell System as a whole (*infra*, 362). But no such revision of contractual relations took place between the American and Chicago Companies prior to April 17, 1918. Such was the situation on that date.

The detailed historical survey follows:

HISTORICAL SURVEY 1876-1919.

Period 1876-1896.

A. Western Union Contract of 1879.

We have already noted the conflict between the National Bell and the Western Union during this period, which culminated in the Western Union Contract of 1879 (R. VI, 1887; *supra,* 39). The provisions of that contract relating to the exchange and extraterritorial services have already been discussed (*supra,* 40). By the same contract, the Western Union withdrew from the manufacture, rental, and use of telephone instruments (speaker and receiver), and turned over all patents and inventions thereon to the National Bell (Article 5, R. VI, 1894). The latter agreed to rent and not to sell telephone instruments in the United States and to pay over to the Western Union 20% of the rent or royalty received by it during the 17-year period of the contract, plus 20% of the net profits on all telephone instruments manufactured by or through it and exported to foreign countries and to Canada (Article 1, R. VI, 1887). The Western Union also gave to the National Bell, without charge, an exclusive license to make and use, and to license others to make and use, all inventions or improvements in telephone appliances used in connection with telephone instruments (Article 5, R. VI, 1894).

B. Program of Expansion by American Bell.

The American Bell, a Massachusetts corporation, having succeeded to the business of the National Bell in 1880 (R. VII, 2444 (16)), proceeded to expand its business in three directions: (1) by entering into a relationship with the Western Electric; (2) by granting licenses for exchange, extra-territorial connecting, and long distance services; and (3) by acquiring a stock interest in licensee companies.

1. *Western Electric Contract of* 1882.

In 1881 the American Bell bought the plant and business of one manufacturer, and a minority stock interest in another which owned patents covering telephone instruments and apparatus. These two businesses were consolidated in 1882 into the Western Electric, an Illinois corporation. The American Bell acquired 50.8% of the original 10,000 shares of Western Electric stock, of which 24% was given as a bonus for a perpetual manufacturing license granted in 1882 (R. VI, 2064, 2068).

This contract has continued in force to date, excepting as enlarged in 1908 (*infra*, 183). Its provisions summarized herein have a vital bearing on the issues in the instant case. By this license contract (R. VI, 2068) the Western Electric was given the exclusive right to manufacture telephone instruments and apparatus under patents then owned or thereafter controlled or acquired by the American Bell or by the Western Electric. The Western Electric agreed: (a) to sell to the American Bell at actual cost all inventions in telephone instruments which the former then owned or might thereafter acquire, (*Idem*, Par. 1), to manufacture telephone instruments only for the American Bell, and to charge to it for such instruments the actual costs of manufacture plus 20%; (b) to give to the American Bell without charge the exclusive right and license to use and sell and to license others to use telephone apparatus under patents then owned by the Western Electric or which it might thereafter acquire (*Idem.*, Par. 3); (c) to manufacture and sell the phone apparatus exclusively to licensees of the American Bell (*Idem*, Par. 4), and to charge them for such apparatus uniform prices, not exorbitant and not unreasonable (*Idem*, Par. 4b); (d) to reimburse the American Bell the entire cost (including royalties to third persons) of any inventions in telephone apparatus manufactured by the West-

ern Electric but developed by the American Bell or thereafter acquired by the latter from sources other than from the Western Electric (*Idem;* Par. 4); and (e) to stand the entire expense of defending itself against infringements (*Idem,* Par. 7).

2. *License Contracts for Local Exchange and Extra-territorial Connecting Service.*

The second step in the expansion program of the American Bell was to develop and extend telephonic communication in the United States. As it did not have the financial resources with which to operate exchanges, it adopted the policy of granting licenses to local companies. The basis for granting these licenses was that—

> "they (licensees) shall furnish capital for establishing and developing the business, and that we (American Bell) shall supply the patents, which for a time are expected to give exclusive rights, and returns large enough to invite capital to an industry involving unusual risks." (R. VII, 2363 (5, 6)).

In large cities (New York, Chicago, and San Francisco) it interested local capital and business men of prominence (R. VII, 2356 (2, 3)). In Chicago a special perpetual license contract was issued to the local Company (R. VI, 1925). In other communities, short term license contracts were issued to enable the American Bell to judge whether the local management could succeed. Where experience demonstrated the practicability of such local management perpetual licenses, embodied in standard forms of contracts, were granted (R. VII, 2350 (6, 7)) as in the case of the Southwestern Bell, the party before this Court in the *Houston Case* (259 U. S. 318).

In our discussion of the long distance arrangement with the Chicago Company we compared the provisions of the standard license contracts, Forms 109D and 113D, with the

Chicago Company's Original License Contract of 1881, relating to the operation of exchange and extra-territorial connecting services (*supra*, 40). We now summarize their respective provisions relating to the matters here under discussion:

By both classes of contracts the American Bell agreed: (1) to lease to each licensee telephone instruments of the best or standard character and pattern in use at the time of delivery (R. VI, 1926 (Sec. 5)); (2) to license for use with such telephone instruments inventions in apparatus "needed for such telephone lines which it can so license upon such royalties as it may from time to time establish, not greater than those fixed for others under similar circumstances" (R. VI, 1927, Sec. 6); and (3) to give to the licensee the right to make a charge to its subscribers for the use of the telephone apparatus over and above the charge established by the parties for the rental of the telephone instruments (R. VI, 1928, Sec. 9). Each licensee agreed: (1) to charge its customers for the use of the telephone instruments such rates as the American Bell might establish from time to time and to pay a percentage thereof to the latter as rent and royalty; and (2) to furnish such information regarding its operations as the American Bell might from time to time request (*Idem.*, Sec. 9).

But the two classes of contracts differed in the following respects: (1) Each standard contract was declared to be personal to the licensee, subject to forfeiture upon its transfer by the licensee or by operation of law. On the other hand the American Bell had the right to transfer title to the telephone instruments—the grantee succeeding to all the rights of the American Bell upon assuming all of its obligations, and the American Bell being released from all future obligations under the license contract (Appendix, 16, 17, 28). On the other hand the Chicago Company's Original License Contract of 1881 was assignable by both

parties but neither party could become released from its continued obligations under the contract (R. VI, 1929 (Sec. 11)). (2) The standard contract provided that "all rights not hereby specifically granted remain to the licensor" (Appendix, 10), while the Chicago Company was given the full use of the telephone instruments "for all purposes" for which the licensor had the right to use the same (R. VI, 1925 (Sec. 2)). (3) The percentage of subscribers' rental paid to the American Bell by the standard licensee was usually larger than that paid by the Chicago Company (Appendix, 11, 21; R. VI, 1928 (Sec. 9)). (4) The standard licensee paid to the American Bell a percentage of the local toll or connecting line revenue, which the Chicago Company did not pay (Appendix, 14, 25). (5) The American Bell agreed to pay all expenses of defense of the Chicago Company in litigation for infringement upon the Bell telephone patents and to sue infringers of such patents in the territory of the Chicago Company or elsewhere to stop the use of infringing telephones in such territory (R. VI, 1932 (Sec. 17))—an obligation not found in the standard contract. (6) Some licensees were also required by special contract (a) to procure the consent of the American Bell to borrow money; (b) to keep books and accounts of their business on forms furnished by the American Bell; (c) to throw open their books and accounts for inspection by an authorized agent of the American Bell; (d) to make the reports of their operations in such form as the American Bell might desire; (e) to elect and maintain two representatives of the American Bell on the directorate and on the executive committee (Appendix, 5). None of these five requirements was imposed on the Chicago Company by the Original License Contract of 1881.

3. *Contract of* 1894 *with American Company.*

The third step in the expansion program of the American Bell dealt with the long distance business between the territories of the licensees. Although the experiments by the American Bell in long distance service proved successful from an engineering standpoint (R. VII, 2358 (6-9); 2360 (9)), it was denied permission by the Massachusetts legislature in 1886 to increase its capital stock to make provision for the moneys required to build up that service (R. VII, 2363 (6, 7)). It therefore caused to be organized for that purpose the American Company, a New York corporation (R. VII, 2364 (6, 7)). The latter company received at first a temporary license, which was converted in 1894 into a perpetual grant (R. VI, 1990), to conduct a long distance business, in consideration of the payment of 25% of its stock to the American Bell (R. VI, 1991). The contract embodied the standard provisions just described, relating to furnishing information, holding the records open to inspection, and assignability by the parties (*supra,* 159).

4. *Stock Investments.*

The fourth step in the expansion program of the American Bell was the acquisition of a substantial interest in the stock of licensee companies (R. VII, 2350 (7)). By pursuing this plan, the American Bell expected "to gradually acquire a large permanent interest in the telephone business throughout the country," so that it "would not be dependent upon royalties for revenue when the patents have expired" (R. VII, 2350 (7); 2352 (1, 2)). The American Bell acquired stock in the local licensee companies by exacting bonus stock for the granting of licenses and/or by purchase (R. VI, 2064, 2068). By the end of 1883, it owned $19,000,000 par value stock, of which $6,500,000 represented bonus stock (R. VII, 2360 (6); R. VI, 2064).

The development program of the American Bell and its licensees in the four directions above mentioned created the necessity for financial assistance to the latter and for the establishment of a large internal organization by the former.

C. Financial Relations of American Bell to Licensees, 1881-1896.

1. *Financial Assistance to Licensees Other Than the Chicago Company.*

In the early years of development, the Bell licensees were required to take over rival companies (R. VII, 2355 (2)); to build underground systems (R. VII, 2352 (3)); to "organize and rebuild their exchanges more than once, as the necessities of the service revealed themselves, * * *" (R. VII, 2358 (6-9)) to purchase new equipment as new developments occurred (R. VII, 2362 (12)). The American Bell used its influence with its licensees "to encourage liberal expenditure for the improvement and extension of plant and for the bettering of service" (R. VII, 2370 (1)), particularly long distance service (R. VII, 2370 (6, 7)). When long distance service was first established, it could not be used in connection with the then existing exchange service. Special lines with special operators had to be provided for customers using long distance service (R. VII, 2524 (43)). The real extension of the latter service could not be expected "until the principal exchanges shall have adopted the metallic circuit system;" (R. VII, 2370 (6)) and "a higher standard of construction and service" than would otherwise be necessary (R. VII, 2370 (6)). The American Bell policy was that "terminal connections and equipment must be built and maintained at a correspondingly high standard, and the details of management and operation

must be in the hands of competent and highly trained employees" in order to make long distance communication possible (R. VII, 2383)). By 1894 the remodelling of the local plans for long distance service was well under way (R. V, 1739, 1740). By the end of 1896, 40% of all local exchange stations were connected by metallic circuits (R. VII, 2385 (11, 12)).

The cost of maintaining and reconstructing the plants exceeded the original estimates (R. VII, 2363 (5, 6)) and in the early years most of the licensees found it impossible to sell bonds or stocks (R. VII, 2360 (7)). They therefore applied all or part of their net earnings to development, and with the consent of the American Bell passed all or part of the dividends on their stocks (R. VII, 2360 (7)). They also required and received financial assistance from the American Bell. In some cases the latter waived its dividends for a few years (R. VII, 2352 (3); 2355 (2, 3); 2363 (5, 6); *Re New York Telephone Co.*, P. U. R. 1923 B, 545 (New York)); in some cases it rebated part of the royalties due to it as rental for telephone instruments; in still other cases it made cash contributions (R. VI, 2091, 2095). Between 1885 and 1896 the rebate in royalties and cash contributions to licensee companies was at least $1,400,000 (R. VI, 2091).

2. *No Financial Assistance by American Bell to Chicago Company.*

The Chicago Company neither required nor received any such assistance during this period. It received no loans or advances of any kind whatsoever; on the contrary it made several loans to the licensees of the Bell System (R. VI, 2097, 2104).

3. *Financial Assistance by Chicago Company to American Bell.*

But the Chicago Company was of great financial help to the American Bell in the cash dividends which it paid and in providing outside capital. The Chicago Company paid cash dividends yearly beginning with 1882, when 32% was paid. In 1883, 40% cash dividends were paid (R. V, 1860). From 1884 to 1891 inclusive the Chicago Company paid yearly cash dividends ranging from 30% to 51% (R. V, 1860) on a capitalization of $2,000,000. From 1892 to 1896 it paid yearly cash dividends ranging from 12% to 20% on a capitalization of $5,000,000 (R. V, 1859, 1860). The American Company's per cent of holding of such stock during the period from 1883 to 1896 ranged from 37% to 51% (R. VI, 1982).

Similarly the Southwestern Bell paid no dividends from 1883 to 1889 and yearly cash dividends thereafter to 1896 ranging from 3.66% to 4.5% (Appendix, 1); during the period 1882-1896 the Missouri Company, the appellant before this Court in the *Missouri case* (262 U. S. 276), paid no dividends for three years and yearly cash dividends during the balance of the period ranging from 2½% to 5% (Rec. Missouri Case, 156). The contrast between the record of the Chicago Company and that of the entire Bell System was equally startling. In 1883, the American Bell received $440,923 cash dividends on its $19,000,000 par value of stock in all operating licensee companies, of which dividends $100,534 came from its holdings of $253,000 par value of stock in the Chicago Company (R. VII, 2357 (2); R. VI, 1982; R. VI, 2120). In 1883 it received no cash dividends from the Western Electric (R. VI, 2064); it received 1.8 per cent cash dividends on its stock holdings in all licensee companies excepting the Chicago Company (R. VII, 2357 (2)); and it received 40%

cash dividends from the Chicago Company (R. V, 1860). The stock holdings of the American Bell in the Chicago Company represented 1.3% of its stock holdings in licensee companies and produced 22.7% of all cash dividends received by it.

In 1892 the American Bell received $1,422,000 cash dividends on its $34,000,000 par value stock holdings in all companies (R. VII, 2376, 2377 (16, 17)), of which dividends $252,000 came from its holdings of $1,300,000 par value of stock of the Chicago Company (R. VI, 1982, 2120). The dividend return to the American Bell for that year from its holdings in the Chicago Company was 20%, while the dividend return on its stock holdings in the other companies was 3.5% (R. VII, 2376, 2377 (16, 17)). The stock holdings of the American Bell in the Chicago Company represented 4% of its stock holdings in all companies and produced 17.7% of all dividends received by it on its stock holdings.

D. Development of General Staff, 1881-1896.

By the end of 1883 the American Bell decided that:

> "With the acquirement of large interests in our licensed companies comes the necessity of more oversight of the business, and, as far as it can be obtained without absolute ownership, an exact comparison of results. The organization of the company should be shaped to meet these requirements, and with proper watchfulness and effort on our part, we may expect steady growth and improvement in the character of our business in all its branches" (R. VII, 2359, (10)).
>
> "• • • our licensed companies should be led to feel that it is for our interest as much as their own that they should be successful" (R. VII, 2363 (5)).

By 1891 the American Bell had established a General Staff to advise its licensees as to apparatus and operating methods and to study and standardize such apparatus

and methods (R. VII, 2601 (7)), and the licensees were encouraged to use the facilities as much as possible (R. VII, 2373 (8)). Thereafter to 1896 there was close cooperation within the Bell System (R. VII, 2374 (8); 2376 (15); 2380 (16, 17); 2381 (16, 17)).

E. Benefits to American Bell from Financial Assistance to Licensees and from Development of General Staff.

(1) *Improvement in Earning Power of Licensee Company Stock.*

In 1883 the American Bell adopted the policy of developing its stock holdings to become its chief source of revenue when the telephone patents expired (*supra*, 161). By 1896 this purpose was accomplished. In 1883 the cash dividends received by the American Bell from licensee companies amounted to 25.9% of the sum received by it as cash royalty from the rental of telephones (R. VII, 2357 (2)). Cash dividends in 1891 amounted to 42.4% of the sum of such royalties (R. VII, 2377 (17)); in 1895 such dividends exceeded the cash royalties by 19% (R. VII, 2383 (15)).

2. *Dividends from Western Electric.*

The American Bell profited also in large degree from the manufacturing end of its business. At the end of 1896 the American Bell held 17,956 shares of the capital stock of the Western Electric, or 60 per cent of the entire capitalization. 70.5 per cent of its holdings represented stock for which the American Bell had paid nothing, being stock dividends and bonus stock given originally for the granting of the manufacturing license in 1882 (R. VI, 2067). 29.5% of its holdings represented a cash and property investment of $549,100. The 17,956 shares cost the American

Bell $30.58 per share, on which it was receiving in 1896 yearly cash dividends of $8 per share. From 1885 to 1896 the Western Electric paid yearly cash dividends ranging from 6% to 13½% and paid three stock dividends, one of 14 2/% and two of 50% each (R. VI, 2066).

F. American Bell Admits Non-Liability of Licensees to Pay for Financial Assistance and for Services of General Staff.

At this point we are able to answer the following questions:

1. Did the American Bell include in the charge for rental of telephone instruments any charge for: (a) any financial assistance given to licensee companies; (b) any improvements in the telephone instrument through inventions or otherwise, since November 1, 1879; or (c) any royalty from the licensee for the use of telephone apparatus in connection with telephone instruments over and above that charged by the Western Electric as part of the purchase price thereof; and (d) any service of business management? The answer: "No!"

2. Did the American Bell give to the licensee companies the benefit of the rights granted or permitted and of the services rendered by it in their behalf, enumerated in question 1, with the expectation of being compensated therefor or of being reimbursed for the expenses thereof? The answer: "No!"

3. Was there any express or implied promise by the licensee companies to pay to the American Bell any compensation or to make any reimbursement to it for the expenses incurred by it in granting the rights or in performing the services enumerated in question 1? The answer: "No!"

The negative answer to each of these questions was given

by the American Bell itself in the controversy which it had with the Western Union in accounting to it for royalties under the Western Union Contract of 1879 (R. VI, 1887).

Western Union Litigation.

We shall now examine the facts developed by this controversy. Under the terms of the Western Union Contract of 1879 (R. VI, 1887) already referred to, the National Bell was required to pay to the Western Union 20% of all rentals or royalties received from the licensing of telephones in the United States (*supra*, 156). We have already noted that the American Bell issued licenses to sundry licensees and received in addition to the annual cash rentals for telephones a percentage of the capital stock of these licensee corporations as bonus stock (*supra*, 161). The Western Union claimed that this stock was rental and royalties within the meaning of the contract and that it was entitled to 20% of the stock and the dividends therein. Suit was brought in 1883 in the District Court of the United States for the First District in Massachusetts for an accounting. The Circuit Judge affirmed the Master's findings in favor of the American Bell as successor to the National Bell (*Western Union Tel. Co.* v. *American Bell Tel. Co.*, 105 Fed. 684) and dismissed the bill, but on appeal to the Circuit Court of Appeals the decision of the Circuit Court was reversed in 1903 (*Western Union Tel. Co.* v. *American Bell Tel. Co.*, 125 Fed. 342). Under this latter decision the American Bell was ordered to turn over to the Western Union 20% of the bonus stocks received prior to 1896 (*Western Union Tel. Co.* v. *American Bell Tel. Co.*, 187 Fed. 425; *Western Union Tel. Co.* v. *American Bell Tel. Co.*, 203 Fed. 785). In 1907 the American Bell filed its Amended Answer, wherein it stated it had incurred expenses "in behalf or for the benefit of its licensee companies for the purpose of increasing the value

and earning power" of these bonus stocks; it had given these same licensee companies "rights under patents (not relating to telephone instruments) for the same purpose" of increasing the value and earning power of these bonus stocks; it had given these same companies other rights or permits "for the same purpose" of increasing the value and earning power of these bonus stocks; it had performed services for the same companies "for the same purpose" of increasing the value and earning power of these bonus stocks, "no compensation or reimbursement for such services, rights or expenses having been required by defendant (American Bell) from said companies because of its understanding under its interpretation of the Contract of November 10, 1879, that it was the owner of all such stocks" (R. VI, 2091; *Western Union Tel. Co.* v. *American Bell Tel. Co.*, 187 Fed. 425, 444, 449-450). The American Company further contended that if the Western Union be held entitled to participate in such bonus stocks, the participation should be contingent upon a corresponding reimbursement of the advances made and expenditures paid (*Idem*, 449-50).

The Circuit Court of Appeals in affirming the lower Court's holding that the Western Union was entitled to receive 20% of these bonus stocks* under a proper interpretation of the Western Union contract, without making reimbursement to the American Company for its financial assistance and services rendered to the licensees, (*Western Union Tel. Co.* v. *American Bell Tel. Co.*, 187 Fed. 425) found that the financial assistance and services of making available improved apparatus and of business management given by the American Company to licensees were necessary incidents for the development of the use of the telephone instruments, from which increased use

*For special reasons, the accounting was held not to apply to the bonus stocks received by the American Company from the Chicago Company (*Western Union Tel. Co.* v. *American Bell Tel. Co.*, 187 Fed. 425, 464).

the American Company would benefit through increased cash royalties and rentals of instruments. The Circuit Court of Appeals said:

> "All this was a matter of course unless it was assumed that the owner of the telephone patents was to be absolutely supine and wait for an overruling Providence to give it the profits which might possibly ensue." (*Western Union Tel. Co.* v. *American Bell Tel. Co.*, 203 Fed. 785, 791-2).

We need only trace the relationship to 1919 to see how far the obligations of the Chicago Company and of the other licensees were created, if at all, to pay for such assistance and services.

Period 1897-1899.

A. Contractual Revisions.

Two revisions in contractual relationships took place in the Bell System: (1) In 1898 the American Bell canceled the obligation of the Southwestern Bell and of the standard licensees to thereafter pay to it the 15% of the local tolls required to be paid under the Extra-territorial contract, Form 113-D, above described (*Re New York Telephone Co.*, P. U. R. 1923-B, 545 (New York); *Re Mountain States Tel. & Tel. Co.*, P. U. R. 1917-B, 198 (Colorado), Appendix, 40); (2) By 1899 the demands of the business required much larger capital than could be provided under the corporate powers of the American Bell. It transferred its business as of the end of 1899 to the American Company, the licensee of the long distance service (R. VII, 2389 (8)). The stockholdings of the American Bell, the license contracts between it and the licensee companies, and the Western Electric Contract of 1882 were all assigned to the American Company. The obligation of the latter to pay 15% of the long distance revenue to the American Bell was terminated (R. VII, 2389 (8)).

B. Benefits of Relationship to American Bell.

1. *Dividends from Western Electric.*

During this period the American Bell was the principal beneficiary of any assistance or services rendered to the Bell licensees or of improvements in the art. Most of the activity of the licensees was to equip their properties for long distance service. By the end of 1899, 55% of all stations were equipped with metallic circuits (R. VII, 2388 (7)). This activity was very profitable to the manufacturing end of the business of the American Bell. At the end of 1899 the American Bell held 56,004 shares or 60% of the total issued stock of the Western Electric, on which stock it was receiving yearly cash dividends of $8 per share (R. VI, 2064). Of these shares, 24,668 or 68.5%, represented bonus stock or stock dividends, of which 12,014 shares were received as stock dividends in 1898-9; 11,336 shares or 31.5% of its holdings represented cash and property investment of $1,500,000 or $32 per share (R. VI, 2066).

for its holdings

2. *Enhancement of American Bell Stock.*

The cash investment in the two original associations organized in 1878 to exploit the Bell patents (R. VII, 2443 (15)) was represented by $100,000 cash, plus the value placed upon the patents and development work to that time. In 1899 there were outstanding 59,500 shares of American Bell stock (R. VII, 2444 (16)), representing an original and total cash investment of $1,380,000. In 1899 these same stocks had a market value in excess of $11,900,000 and were receiving 15% yearly cash dividends (R. VII, 2443, 2444, 2445 (16, 17)).

Period 1900-1902.

A. Contractual Revisions—4½% Modification of 1902.

At the end of 1902 the American Company modified the respective license agreements theretofore made by the licensees with the American Bell and provided that "a new and simpler plan for determining the amounts to be paid this company as rental for telephones" should be effective as of January 1, 1902 (R. VII, 2396 (10)). Under all the original license agreements, the rental to be paid to the American Bell was computed at a percentage of the charge made by each licensee to its subscribers. Under the Original License Contract of 1881 (R. VI, 1925) the rental for the use of the telephone instruments was 50% of the subscriber's charge, and under the standard license contract, 70% of such charge (Appendix, 11, 21). By the revision of 1902 the American Company, acting in the name of the American Bell, agreed "to substitute for the rental upon Telephone Instruments (magneto telephones and battery transmitters)" payable under the license contract with each licensee, an agreement whereby all licensees, including the Chicago Company, agreed to pay to the American Company as and for such rental, 4½% of their respective gross earnings* (R. VI, 2087).

*This plan involved a reduction of 30% in the average rental per instrument paid to the American Company for the year 1902 (R. VII, 2396-10, 2398 (17)). But as the Chicago Company had theretofore been paying a percentage of rental per instrument which was 20% less than the percentage paid by the standard licensee, the reduction was of greater benefit to the standard licensees than to the Chicago Company. In spite of this reduction in revenue, the American Company felt that "this modification of the rental arrangement was clearly justified by the existing conditions. It is believed that it will work to the advantage not only of the operating companies, but of this company." (R. VII, 2396 (10)). As the number of telephones in the hands of licensees increased 25% during that year, (R. VII, 2392 (3)), the reduction in rental revenue to the American Company for the year 1902 on account of this change was only 13% (R. VII, 2398, (17)). The investment in telephones, as shown on the books of the American Company, was $6,500,000 (R. VII, 2397 (16)). The rental revenue for the year 1902, after the reduction, was still $2,300,000, or a return of 30% (R. VII, 2398 (17)).

B. Benefits of Relationship.

The following facts show that the American Company was the principal beneficiary during this period of any assistance or services to licensees and of the improvement in the Art.

1. *Long Distance Revenues.*

The American Company, as the operator of the long distance service and parent of the Bell System, sought the further extension of its long distance service both by re-equipping existing exchange facilities and by equipping new facilities. Most of the increase of exchange stations beginning with 1900 concerned those connected with metallic circuits (R. VII, 2389 (10)). In the City of Chicago the number of stations tripled in the three-year period (R. VI, 2299); in the balance of the Bell System the number doubled (R. VII, 2396 (15)). As a result of these gains, plus the replacement on existing stations, the number of stations connected with metallic circuits more than doubled in the first two years of the century (R. VII, 2389 (8), 2390 (6, 7)). Not only did the long distance revenue increase materially in 1901-1902 (R. VII, 2398 (17)), but there was a special profit to the American Company therefrom beginning with 1900. By succeeding to the business of the American Bell, the American Company eliminated its own obligation to pay the former 15% of its gross revenues from long distance business, which it had been paying since 1894 (R. VI, 1990).

2. *Western Electric Dividends.*

In 1901-2 improvements in cables were made which revolutionized the art of telephone line construction. Entire wire lines were scrapped by licensees and cable substituted, and whole lines were rebuilt to provide for the necessary

growth (R. VII, 2418 (7, 8)), for all of which the licensees paid. This activity on the part of the American Company and of the licensees, and the improvements in the art, proved very profitable to the Western Electric, which profitableness in turn reflected itself in larger dividends to the American Company. In the three-year period the American Company received from the Western Electric two stock dividends—one of 14-2/7 % and one of 25%, aggregating 18,021 shares—and purchased at par 6,000 shares of stock. At the end of 1902 the 60,000 shares held by the American Company represented a total cash investment of $1,900,000, or $31 per share, on which stock it was receiving $8 per share yearly cash dividends. On the cash invested since 1899 the American Company was receiving at the end of 1902 cash dividends at the rate of 36% per year (R. VI, 2066).

3. *Revenue From Licensee Companies.*

The increased activity by the American Company and the licensees added to the return to the American Company through the enhanced yield on stock investment and through increased revenue from rentals of telephone instruments. This was particularly true in Chicago.

(a) CHICAGO COMPANY.

The rental on telephone instruments paid in 1901 by the Chicago Company was 90% greater than that paid in 1894, the first year after the expiration of the Bell patents; and 63% greater than that paid in 1899 (R. VI, 2085). In 1902 the American Company was receiving 10% yearly cash dividends on all of its 56,000 shares of stock in the Chicago Company (R. VI, 2120), which stock represented a cash investment of less than $85 per share* and a market

*The American Company received a stock dividend of 16% in 1900 (R. V, 1860; R. VI, 2120).

value during that year of $160 a share at the low and $230 a share at the high market price of 1902—an enhancement of from $4,000,000 to $8,000,000 in value (R. VI, 2275).

(b) SOUTHWESTERN BELL AND MISSOURI COMPANIES.

Contrast this record with that of the Southwestern Bell, which paid yearly cash dividends of 4% in 1900, 8% in 1901, and 2.2% in 1902 (Appendix, p. 1), and with that of the Missouri Company, which earned and paid yearly cash dividends of 7% in 1900 and 6% in 1901-2 (Rec. Missouri Case, 156).

Period 1903-1907.

A. Contractual Revisions—Cancellation of Standard License Contract with Southwestern Bell.

1. On November 1, 1907, the American Bell and Southwestern Bell cancelled the standard license contracts already described which had created and defined their relationship, and entered into a new agreement which provided that:

> "said The American Bell Telephone Company *shall continue to furnish said The Southwestern Telegraph and Telephone Company telephone instruments, license their use, and the use of telephone appliances,* so long as this agreement remains in force, under all patents now or hereafter owned or controlled by it, said The American Bell Telephone Company, and furnish *other services and things as heretofore, and said The Southwestern Telegraph and Telephone Company shall pay to said The American Bell Telephone Company the same consideration in money which it has heretofore paid under the terms of the letter of said The American Telephone Company,* dated November 21, 1902." (Appendix, 39). (Italics ours.)

2. *Contract with the Chicago Company Neither Revised Nor Cancelled.*

THERE WAS NEITHER A REVISION OF THE ORIGINAL LICENSE CONTRACT OF 1881 NOR ANY NEW ARRANGEMENT, UNTIL THE 1919 MEMORANDUM WAS MADE EFFECTIVE ON FEBRUARY 1, 1919, BETWEEN THE CHICAGO COMPANY AND THE AMERICAN BELL OR THE AMERICAN COMPANY, BY WHICH THE 4½% PAYMENT WAS ADOPTED AS THE MEASURE OF COMPENSATION FOR THE RENTAL OF THE TELEPHONE INSTRUMENTS AND FOR THE LICENSE TO USE PATENTED TELEPHONE APPARATUS AND FOR THE RIGHT TO RECEIVE OTHER SERVICES FROM THE AMERICAN BELL AND/OR FROM THE AMERICAN COMPANY.

The failure of the Chicago Company and of the Statutory Court to give effect to the difference in the contractual relationship existing in the instant case and in the case of other Bell licensee companies is responsible for their erroneous position in the case at bar.

B. Benefit of Relationship.

1. *Joint Enterprise of American Company and Licensees.*

The following facts show that the improvement in the art during this period was the result of the joint effort of the American Company and other Bell licensees; the American Company was the principal beneficiary of any service or assistance to licensees. From 1902 to 1908 the energies and the genius of the American Company and of the Bell licensees were joined in a combined effort to dominate the telephone field. Even prior to 1900 the Bell System had keen competition from independent telephone companies (R. VII, 2395 (8)). In some places there were duplicate systems in the same community which led to destructive rate wars (R. VII, 2395 (9)). By the end of 1902 the Bell

System adopted a definite policy to meet this situation (R. VII, 2401 (9, 10)). It determined to procure for itself sole recognition as offering the only desirable telephone service (R. VII, 2395 (8); 2417 (5, 6)) by providing (a) more extensive facilities, (b) better service, and (c) better relations to the public, than its competitors (R. VII, 2418 (9, 10)). The more extensive facilities were to be provided through the extension of the area of communication beyond local boundaries to the entire country (R. VII, 2317 (5)); the better service was to be rendered by all operating companies and by the American Company itself through the perfection of apparatus and the discovery of improved methods of operation; and better public relations were to be attained through the training and discipline of employees.

2. *Steps Taken by American Company and Licensees to Carry Out Joint Enterprise.*

Executives, officers, engineers, and traffic men of the licensee companies made every effort to keep the service at the highest possible standard of efficiency (R. VII, 2400 (6, 7)); 2415 (19); 2421 (13, 14)) through systematic organization, through improved methods of accounting (R. VII, 2411 (7, 8)), and by devising and putting into effect standard methods of operating (R. VII, 2400 (6, 7)). Improvements in apparatus and methods were designed to render more efficient intercommunication among the subscribers of the various licensee companies of the Bell System (R. VII, 2410 (7, 8)). This was accomplished by standardizing exchange and toll equipment (R. VII, 2394 (7, 8); 2433 (5, 6)); by standardizing methods of operating (R. VII, 2400 (6, 7)); by improving cable construction and placing exchange wires underground (R. VII, 2412 (9); 2433 (5, 6)); by using standard methods of engineering in all new work and in the reconstruction of old work (R. VII, 2411 (7, 8)); and by building special equipment to make telephone service acces-

sible to the public (R. VII, 2410 (5, 6)). Scientific studies were developed for plant construction and expansion (R. VII, 2419 (9, 10)) to provide for durability and for permanency of standard (R. VII, 2433 (6)); to provide for apparatus of a permanent type (R. VII, 2400 (6, 7)); 2411 (7)); to provide for additions to plant on predetermined lines (R. VII, 2418 (9, 10)); to provide for installation of facilities not only to take care of business actually in sight but to take care of future demand* (R. VII, 2417 (6)).

3. *Small Contribution by American Company to Joint Enterprise.*

It is pertinent to note how disproportionate was the financial contribution of the American Company compared to the profit to it arising from the joint enterprise. The expenditures by the licensee companies for construction for the years 1903 to 1907 inclusive, aggregated $251,000,000 (R. VII, 2423 (5)). The increase in investment in these companies by the American Company during this period was $158,000,000 (R. VII, 2397 (16); 2430 (33)) or 60% of net additions. The relationship of the American Company to the Chicago Company was financially even less helpful than to the average of the Bell System. In the case of the Chicago Company the net additions to plant during the period 1903 to 1907 inclusive, were $14,300,000 (City Ex. 80, opposite R. VI, 2120). The increase in cash investment in the Chicago Company by the American Company during that period was $3,100,000 (R. VI, 1982, 2120), or 22% of net additions. This increase in investment was in stock at par in 1903 and 1907. In 1903 the market price of Chicago Company stock ranged from $160 to $230 per share, and in 1907 from $95 to $134 per share (R. VI, 2275). Dur-

*By the end of 1906 "$25,000,000 are invested in circuits in cable that are not yet in use but all of which will soon be in service," (R. VII, 2419 (11)).

ing the five year period the American Company's percentage of holdings in the Chicago Company increased 2.3%, being 55.3% of the outstanding stock at the end of 1907 (R. VI, 1982). During the five years the only financial assistance received by the Chicago Company from the American Company was a loan of $750,000 for a period of five months in 1907 (R. VI, 2097).

4. *Profit to American Company From Joint Policy.*

(a) WESTERN ELECTRIC DIVIDENDS.

The carrying out of the joint enterprise was highly profitable to the Western Electric, which profitableness in turn reflected itself in larger profits to the American Company. The expenditures by the licensee companies for construction for the years 1903 to 1907 inclusive, aggregated $251,000,000 (R. VII, 2423 (5)).* During this period (1903-1907) the American Company received a 20% stock dividend of 12,015 shares and purchased 18,022 shares at par, thereby increasing its cash investment in the Western Electric to $3,702,200. For this cash investment it held, in 1907, 90,066 shares, or 60% of the capitalization, at a cost of $40 per share. 40% of its entire holdings in 1907 was bonus or dividend stock, which represented over 25% of the entire capitalization of the company (R. VI, 2066). During the entire period the Western Electric paid yearly cash dividends of $8 per share on its entire capitalization.**

*The purchases of the Chicago Company during the same period were $8,900,000 (R. VI, 2062).

**No account is taken of the enhancement in market value of these stocks over the par value, nor of the undivided profits and surplus of the Western Electric. The American Company admitted that at the end of 1907 the plant of the Western Electric was carried on the books of that company at 51% of the actual cost (R. VII, 2424 (8, 9)). It considered that certain extraordinary expenditures made in 1908 by the Western Electric were justified, "particularly when we take into account the very large surplus of the company on the books and the much greater actual surplus" (R. VII, 2434 (13)).

(b) INCREASE IN TELEPHONE RENTAL REVENUE.

By the end of 1907 the number of stations operated in the Bell System was 5 times the number operated in 1899 and 2.4 times the number operated on January 1, 1903 (R. VII, 2396 (15); 2423 (3, 4)). The number of telephones in service in Chicago increased 93% from 1903 to 1907 (R. VI, 2299) and the instrument rental paid the Chicago Company during that period increased 120% (R. VI, 2085).

(c) CONNECTIONS WITH INDEPENDENT COMPANIES.

Beginning with 1902 the Bell System connected with independents in territory not occupied by Bell Licensees (R. VII, 2401 (9, 10); 2406 (12)). This practice was encouraged wherever the Bell licensee avoided thereby the necessity of duplicating an existing plant to occupy that territory (R. VII, 2407 (11, 12)). By the end of 1907, 755,316 independent telephone stations were connected, or 25% of the stations operated by the Bell System (R. VII, 2423 (3, 4)). This expansion was particularly valuable to the American Company both in the extension of long distance service and in the expansion of the field for the products of the Western Electric.

(d) INCREASE IN LONG DISTANCE REVENUES.

In the five years the long distance revenues of the American Company aggregated over $34,500,000 and the average net increase for each year of this period over the year 1902 was $4,800,000 (R. VII, 2403 (17); 2408 (19); 2422 (23); 2431 (34)). At least 15% of the net increase, or $720,000 per year (aggregating for the period $3,600,000), represented additional net income to the American Company by virtue of its terminating its own contract with the American Bell in 1899 (*supra*, 170).

(e) DOMINANT POSITION OF BELL SYSTEM IN THE TELEPHONE FIELD ESTABLISHED.

By the end of 1904 the fact that the Bell System was national in scope was being recognized by the public, entitling the Bell System, as a public utility, to a position which could not be attained by rival organizations that were, relatively speaking, largely local in character (R. VII, 2406 (11)). By the end of 1905 a considerable number of companies which had operated in direct competition with the Bell exchanges, made peace and connected up with the Bell System through sub-license contracts (R. VII, 2415 (19)). By the end of 1907 there was one Bell telephone station to each twenty-two of the total population in the United States (R. VII, 2431).

(f) STABILIZATION OF EARNINGS OF BELL SYSTEM.

The dominant position of the Bell System established a corresponding stabilization of earnings within the System.

At the end of 1907 the American Company owned stocks of the licensee companies in the aggregate par value of $202,300,000 (R. VII, 2430 (33)). In the year 1907 cash dividends received by the American Company from all of its stockholdings averaged 5.9% (R. VII, 2431 (34)) as against 1.8% in 1883 and 3.1% in 1891 (R. VII, 2376 (16)). Even the Southwestern Bell dividends became stabilized, at 6.03% in 1903, 5.50% in 1904, 5.60% in 1905, 6.90% in 1906, 6.25% in 1907 (Appendix, 1). At the end of 1907 the American Company held $9,300,000 par amount of stock in the Chicago Company, on which it received 10% yearly cash dividends (R. VI, 1982, 2120).

Summary to 1908.

From the foregoing facts it is clear that during the period 1903-1907:

1. There was no revision or change in the contractual relationship between the American and Chicago Companies which increased their respective rights and obligations beyond those existing and defined in the Western Union litigation (*supra*, 167). There was a definite change in 1907 in the contractual relationships between the American Company and some standard licensees, including the Southwestern Bell, which did increase their respective rights and obligations beyond those existing and defined in the Western Union litigation (*supra*, 175). Such revision included the services of making available improved apparatus, of financial assistance, and of business management as part of the services to be covered by the percentage of gross operating earnings which prior thereto had been adopted as a measure of compensation for the use of telephone instruments.

2. The development of apparatus, service, and organization in the Bell System was the joint effort of the American Company and of the Bell licensees, each contributing its share, as part of the program to bring the Bell System to a dominant position in the telephone field. The contribution by the Chicago Company and the profit therefrom to the American Company was greater than that by and from the average of the Bell System.

3. Before leaving the period we also call attention to the following:

In 1881 the American Bell sought to interest capital by granting licenses to the licensees so that "they (licensees) shall furnish capital for establishing and developing the business, and that we (the American Bell Telephone Com-

pany) shall supply the patents, which for a time are expected to give exclusive rights, and returns large enough to invite capital to an industry involving unusual risks" (R. VII, 2363 (5, 6)).

By the end of 1907 the unusual risks had disappeared (R. VII, 2429 (27-28)). Beginning with 1908 new considerations determined the continued relationship between the American Company and its licensees.

Period 1908-1918

A. Contractual Revisions.

Four matters covering the contractual relationships within the Bell System need be noted:

(1) On December 16, 1912, the American and Chicago Companies modified the method of determining the amount on which the 4½% of the gross earnings (as provided for in the Modification of 1902) should be paid to bring the accounting in line with the accounting rules of the Interstate Commerce Commission. (R. VI, 2081-2082.) But no modification was made as to the services intended to be covered by such payment.

(2) In 1916 the American Company interpreted the 4½% payment under the Modification of 1902 as being the measure to be used for rental for the telephone instruments only and not as being compensation for any other services. (Appendix, 55.)

(3) The Western Electric contract of 1882 (R. VI, 2068) and the license contracts with the licensee companies were modified in 1908 to the extent of permitting the Western Electric to sell (a) telephone instruments and (b) telephone apparatus using the American Company patents and licenses to independent telephone companies. (R. VI, 2075; R. III, 1102, 1103.) These revisions gave to independent

licensee companies the same benefit of the development and research, the patents and licenses, of the American Company and of the Western Electric, embodied in these manufactured products, as was given to the Bell licensees, including the Chicago Company. The independent companies paid only one compensation for such apparatus or instruments, which was the purchase price on each to the Western Electric. Such purchase price included the price for the article itself, plus royalty, if any, for the use of patents or licenses. But they paid no additional royalty or compensation to the American Company for the use of such patents or licenses. The effect of such revisions was two-fold:

(a) The total maximum royalty which the American Company could legally exact from the Chicago Company after 1908 over and above the purchase price paid to the Western Electric for patented apparatus, was measurable and limited by the margin in favor of such prices as against the prices paid, on a comparable basis, for the same apparatus when purchased by non-licensee telephone companies.

(b) The maximum rental which the American Company could legally exact from the Chicago Company after 1908 for the use of the telephone instruments, plus any royalty for the use of patents and licenses thereon, was measurable and limited by the annual charges based upon the price of such instruments to non-licensee companies.

B. Benefit of Relationship.

The following facts show that the development of the art was the result of the joint effort of the American Company and the Bell Licensee Companies, and that the American Company was the principal beneficiary of any possible assistance or service, if any, rendered by it to licensees.

1. *Chicago Company Received no Financial Assistance from the American Company,* 1908-1918.

The financial policy of the Bell System in its program of unification after 1908 was defined by the American Company as follows:

> "The interdependence of the systems of the various companies was so great that failure to maintain proper service in any one was to the disadvantage of the others as well as to itself. * * * The difficulty at all times for some of the companies to finance themselves, and the impossibility at times for others, made some systematic and comprehensive and co-operative financial system obligatory. * * * Through co-operation in financial matters all could be sure of capital to meet all requirements as they arose, one margin of idle capital could be carried for the benefit of all, and the advantage could be taken *for all* of favorable financing conditions existing for any one." (R. VII, 2525 (44)). (Italics ours.)

The discrimination against the Chicago Company through its contribution to this cooperative financing program is disclosed by the financial transactions between the American and Chicago Companies, during the entire period from 1908 to July 7, 1918, in comparison with those between the American Company and the other parts of the Bell System. They are:

(a) CREDIT TRANSACTIONS.

In 1908 the American Company advanced $1,250,000 to the Chicago Company for an average period of three months (R. VI, 2097). In this year the Chicago Company did not borrow from banks (R. VI. 2111); (b) in April, 1912, the American Company endorsed and sold to the Chicago Company fifty-nine demand notes aggregating $12,000,000 issued by the Central Union Telephone Company (hereinafter referred to as Central Union) and bear-

ing 5% or 6% interest (R. VI, 2104, 2105). Many of these notes had been issued as far back as 1905 (R. V, 1606). The Chicago Company paid cash for these notes through the sale of its own $14,000,000 first mortgage bonds (R. V, 1608). As bearing upon the character of the notes and the extent of burden on the Chicago Company as a result thereof, the City offered in evidence its City Exhibit 78 (R. I, 427), which was refused admission by the Statutory Court as being immaterial (R. III, 1151). This exhibit was a copy of the Temporary Injunction entered on February 8, 1913, in the case of *Read et al.* v. *Central Union Telephone Co. et al.*, in the Superior Court of Cook County, Illinois, in a minority stockholders' suit against the Central Union, in which suit the American and Chicago Companies were made parties defendant, and by which temporary injunction the Chicago Company was enjoined from seeking to enforce the indebtedness represented by the Central Union notes and from transferring, assigning, and pledging, or in any way disposing of them. This temporary injunction, outstanding in 1913, rendered the notes non-negotiable and unavailable as an asset of the Chicago Company. The evidence was clearly admissible and its exclusion was prejudicial error. (No. 63 Assignment of Errors; R. I, 211.) At the end of 1913 the American Company repurchased the Central Union notes from the Chicago Company and paid for them by giving its own note for $7,550,000 bearing 5½% interest.* $5,550,000 was paid back to the Chicago Company by October, 1914, and $2,000,000 by April, 1916 (R. VI, 2105); (c) in 1916 the Chicago Company advanced to the American Company $1,000,000, half of which was paid in three months and half in four months

*During the year 1912 the Chicago Company resold $1,700,000 of these notes to the American Company. In 1913 the Chicago Company borrowed $2,500,000 from the American Company at 5.88% interest, which indebtedness it satisfied by a transfer of an equivalent principal amount of Central Union notes (R. VI, 2097).

(*idem.*); and (d) in 1917, the American Company advanced for a period of thirty days to the Chicago Company $500,000 (*idem.*)

(b) STOCK TRANSACTIONS.

In 1908 the American Company received a stock dividend of 123,000 shares (R. VI, 1982; R. V, 1859), whose market value ranged from $106 per share on the low market value to $152.25 per share on the high market value for the year (R. VI, 2275). In the same year the American Company subscribed at par for 22,400 shares, being its 52% pro rata portion of increased capital stock. At the same time all of the stock, including the newly issued and dividend stock, was placed on a yearly $8 cash dividend basis, which has continued to date (R. V, 1860). In 1911 the American Company acquired in the open market over 11,000 shares of stock by trading share for share of its stock for the stock of the Chicago Company held by the public (R. VI, 1982, 2273; R. VII, 2475 (25, 26)). The market price of the two stocks in that year ranged from $131.50 per share on the low to $153.12 per share on the high for the American Company stock and from $115 per share on the low to $141.25 per share for the Chicago Company stock (R. VI, 2275). In the three-year period of 1916-1918 the American Company subscribed at par (R. V, 1834) for its 98% pro rata portion of the 100,000 shares of increased capital stock issued in these years* (R. VI, 1982; R. V, 1859; R. VI, 2120).

*After 1912 there were no open markets for the stock of the Chicago Company (R. VI, 2275).

2. *Financial Assistance by American Company to Licensees Other Than Chicago Company*—1908-1918.

The reverse of the Chicago Company situation prevailed in the Bell System. At the end of 1909 the American Company held bonds and capital advances of the Associated Companies in excess of $53,000,000, representing loans made theretofore to weak companies (R. VII, 2452 (38)), especially those who were in the fields of competition with independent companies (R. VII, 2474 (19)). Some of these advances were made as far back as 1905 (R. VI, 2116; R. V, 1606). Included in such companies were the Missouri Company, whose indebtedness to the American Company in 1910 was at least $10,000,000 (Rec., Missouri Case, 174), and the Central Union, whose indebtedness to the American Company in the same year was at least the same amount (R. VI, 2116). During 1910 and 1911 over $23,000,000 of such capital advances were exchanged for stock of the borrowing companies, which companies, for the most part, paid no dividends, resulting in a decrease in yearly revenue to the American Company of $825,000 (R. VII, 2474 (19)). Included in such exchanges was that of $10,000,000 principal amount of demand note indebtedness from the Missouri Company bearing 6% interest for an equivalent par amount of stock in the same company. No dividends had been paid or earned on the stock of that company since 1906 and none was earned or paid thereon to 1917 (Rec., Missouri Case, 156). From 1906 to 1912 the Missouri Company did not even earn its interest (*Idem.*, 175). The American Company continued after 1912 to advance money to the associated companies. By the end of 1917 these loans aggregated $120,000,000 (R. VII, 2568 (54)). In 1918 the average loans from the American Company to the Bell System aggregated $104,000,000 (R. VI, 2291), none of which was to the Chicago Company (*Idem.*).

For every hundred dollars of investment in Bell licensee companies in 1918, other than in the Chicago Company, the American Company was a creditor of the other Bell Companies to the extent of $22 (Appendix, 79).

3. *Rebate of Interest to Bell Licensees Other Than the Chicago Company.*

As the interest charged on these loans was 5.88% and the cost of borrowed money to the American Company in 1918 was 8.33% (R. V, 1809; R. VI, 2296), it is obvious that the reduced rate of interest charged to the Bell licensees* amounted to a substantial rebate from any payments made by them to the American Company, which rebate was not given to the Chicago Company.

The extent of these rebates to the other licensees is disclosed by the following comparisons:

(a) CENTRAL GROUP.

The 4½ per cent license payments by the five companies of the Central Group organized as one operating unit in 1911 (*supra*, 65) were:

Wisconsin Tel. Company	$245,966.97
Cleveland Tel. Company** ..	153,837.15
Michigan Tel. Company†.....	378,360.40
Central Union	520,000.00
Total license payments.....	$1,298,164.21
Chicago Company	1,018,664.21

(R. VI, 2292).

*The text asumes that the borrowing licensees could borrow money as cheaply as could the American Company. This is most favorable to them. The Treasurer of the Missouri Company testified that the earning record of his company precluded the possibility of its borrowing or raising capital at any cost to meet its financial requirements (Rec. Missouri Case, 351).

**Name changed to Ohio Bell Telephone Company in 1920.

†Name changed to Michigan Bell Telephone Company in 1924.

The total loans from the American Company to the same five companies outstanding in 1918, were:

Chicago Company	$ none
Wisconsin Tel. Company	231,587.50
Cleveland Tel. Company	5,405,118.00
Michigan Tel. Company	10,636,250.00
Central Union	35,620,000.00 (R. VI, 2291).
Total	$51,892,955.50

Since the rate of interest on these loans was 5.88% (R. V, 1809), and since the American Company paid 8.33% for moneys borrowed by it during that year (R. VI, 2296), the extent of reduction in interest charge to each of these four borrowing companies in 1918 (assuming that they could procure funds at the same cost as the American Company) was:

Wisconsin Tel. Company	$ 5,673.89
Cleveland Tel. Company	132,425.39
Michigan Tel. Company	260,588.12
Central Union	872,690.00
Total rebate in interest	$1,271,377.40

The rebate in interest to the four borrowing companies represented 98% of their total license payment to the American Company. $26,787.12, or 2%, represented the payment by these companies available for payment of rental for 1,110,499 sets rented by them in 1918. The rebate in interest represented $1.14 per set of telephone instruments; the balance available for rental of the sets was 2½¢ per set.*

*The saving to the borrowing licensees represents a corresponding cost to the American Company. If it be claimed that these loans were from previous years and did not represent new financing, the answer is that the loans are demand loans; as the American Company raises capital yearly, if the moneys borrowed by licensees in previous years on demand were paid off, it would be saved to that extent the cost of financing its own requirements.

In 1918 the 4½% licensee payments to the American Company by each of the five companies, less the actual amount of rebate in interest to the borrowing companies, was:

Chicago Company	$1.55	per set
Wisconsin Tel. Company	1.14	" "
Cleveland Tel. Company	.20	" "
Michigan Tel. Company	.34	" "
Central Union	.70	" " (red)

In 1918 the Central Union claimed the fair annual rental of telephone sets to be $1.03 per set; the Illinois Public Utilities Commission found 55¢ set to be a fair annual rental in 1918 (*infra*, 196). On either basis the gross discrimination against the Chicago Company is apparent. It is equally apparent that gross discrimination between licensees may be created by the American Company through charging them all on the same basis for the right to receive a group of services of variable nature and involving essentially different costs and benefits, where the licensees require such services in extremely varying amounts.

(b) THE SOUTHWESTERN BELL AND CHICAGO COMPANIES COMPARED.

A comparison between the situation of the Chicago Company and the Southwestern Bell in 1918 is equally striking, and is particularly illuminating as the number of stations in the two companies was almost the same.* The Southwestern Bell owed the American Company $10,505,221 (R. VI, 2291). The rebate in interest to the Southwestern Bell was reflected as follows:

	Chicago Company	Per Cent	S. W. Bell	Per cent of 4½% Payment
Loans	.....	....	$10,505,221	....
Rebate in interest	.....	....	257,378	24%
Annual Rental per set†	$740,962	73%	758,357	69%
Available for other services	277,702	27%	76,628	7%
Total Licensee payment	$1,018,664	100%	$ 1,092,364	100%

This does not take into account the fact that the Chicago Company paid 8% cash dividends on its stock while the Southwestern Bell paid only 5% (Appendix, 1).

(c) MISSOURI COMPANY AND CHICAGO COMPANY COMPARED.

The Missouri Company owed the American Company on June 30, 1919, demand loans made in previous years of $25,614,086.19 (Rec., Missouri Case, 161), on which it paid 6% interest (*Idem*, 351-2). If we use as a basis of computation the difference between the 6% charged by the American Company and the cost to it of funds in 1918, to-wit, 8.33% (R. VI, 2296), the rebate in interest alone to the Missouri Company was $596,800 as compared to a total

*The Chicago Company had 655,719 sets; the Southwestern Bell 671,112 (R. VI, 2293).

†The anual rental of $1.03 per set is used as claimed fair by the Central Union in the Peoria Rate Case as already noted (R. VI, 2129). In the Missouri Case, the American Company's representative represented the fair annual rental to be $1.17 per set (Rec. Missouri Case (479).

4½% payment by it of $316,452 for the year ended June, 1918 (Rec., Missouri Case, 633). If we use the difference between the cost to the American Company of 7.17% to procure funds in 1919 (R. VI, 2296) and the interest charged to the Missouri Company, the rebate in interest of $299,684 absorbed over 94% of the entire 4½% payment, leaving 6% of the 4½% payment available for telephone rental as against the 100% of the 4½% payment made by the Chicago Company available for such rental.*

The above discrimination against the Chicago Company does not take into account the fact that it was paying the American Company 8% dividends on its stock holdings while the Missouri Company paid only 5% dividends (Rec., Missouri Case, 159), on its $30,500,000 outstanding capital stock (*Idem.*, Rec., 161), of which the American Company held over 99% (*Idem.* 172).

C. Transfer of Business Management of Chicago Company to American Company.

We have already noted that in 1908 the American Company began, and by 1918 completed, the reorganization of the licensee companies, including the Chicago Company, to operate them as departments of the Bell System, functioning as a single operating unit, with the American Company as the responsible head, and offering an efficient nationwide unified telephone service without limitation of distance or of property ownership, or of legal restraints in the administration of the affairs of the Bell licensees incident to their separate and distinct corporate existence (*supra*, 65). As part of this reorganization, the American Company relieved the licensee companies of the necessity of maintain-

*The record in the Missouri Case does not disclose the number of telephone sets to which the entire 4½% payment is applicable (Rec. Missouri Case, 633).

ing any organization other than an operating organization (R. VII, 2525 [45]). In lieu thereof it substituted its own service of business management, making use of the central organization which it had built up in the past in the manner and for the reasons above stated, and of the accumulated data acquired by it through its association with the Bell licensee companies during the period of their past relationship.

Beginning with 1907 the American Company began the revision of the Original Bell License contracts, as in the case of the Southwestern Bell (*supra*, 175), by which revision each licensee was made to contribute to the maintenance and expenses of the management service transferred to the American Company, which management service the latter obligated itself thereafter to supply. The percentage of gross revenue of each such licensee theretofore used as a measure of cash rental of royalty for the use of telephone instruments was adopted as the perpetual charge for such use plus the perpetual contribution to such maintenance and expenses of the centralized management service, including the services of financial assistance, of making available inventions and improvements embodied in manufactured apparatus, and of business management, the surplus over and above the actual cost and expenses thereof to remain in the treasury of the American Company for the benefit of the Bell System as a whole (*infra*, 367). But no such revision of contractual relations took place between the American and Chicago Companies prior to July 17, 1918.* By the Original License Contract of 1881, as revised in 1902 and in effect on July 17, 1918, the 4½% of the gross operating revenue of the Chicago Company paid yearly to the American

*In 1917, a draft of the revised license contract was submitted by the American Company to the Chicago Company but apparently nothing came of it (R. IV, 1585).

Company was intended by the parties as *rental* only for the use of the telephone instruments leased to the Chicago Company. Such was the situation in 1918.*

Circumstances leading up to 1919 Arrangement In Re License Payment.

PEORIA RATE CASE (P. U. R. 1918 E, 74).

The events in 1918 leading up to the 1919 Memorandum are as follows:

In a proceeding (hereinafter referred to as the Peoria Rate Case) before the Public Utilities Commission of Illinois commenced in 1915 against the Central Union, one of the Central Group, to reduce the rates then in force in the City of Peoria, the propriety of the company's setting up the 4½% payment as an operating expense was challenged. On April 17, 1918, the Public Utilities Commission entered its final order (R. VI, 2123) holding (R. VI, 2127):

> "The propriety of the so-called 4½ per cent charge has been considered by many State Utility Commissions and they have not been uniform in their findings and conclusions. * * * The only justification for this charge is the contract of 1902 between the American Company and respondent and the services therein mentioned in the rental of receivers, transmitters and the induction coils, and there can be no serious contention but that the charge of 4½% of the gross receipts of respondent is an unfair and unreasonable charge for the services specified in said contract and which are the only services this Commission can consider in determining this question.
>
> It is urged on behalf of the American Company that it maintains an engineering and accounting staff, a legal department dealing with patent matters as well as general legal questions, an executive department advising and assisting on all questions that may arise and directing financial aid and assistance to its subsidiary

*The summary of this historical survey is given, *supra*, 149.

> corporations, and that respondent has been receiving all such assistance without other charge than the 4½ per cent charge in question. The Commission is not passing on the necessity or value of such assistance to the respondent, but cannot consider it in the absence of any contract or agreement defining the nature and necessity of such services and the reasonable compensation which should be exacted for each and every one of them, and in the absence of such contract or agreement of this Commission can only consider such services as voluntary contributions from the American Company to the respondent, justified by reason of its stock ownership and direct control. The Commission will therefore consider what is a just and reasonable charge to allow the American Company as rental for the equipment owned by it and used by respondent in the operation of its plant at Peoria."

The Central Union claimed $1.03 but the Commission found only 55¢ per set as a fair annual rental therefor and allowed only that amount as an operating expense (R. VI, 2129). This Order was in full force and effect on July 17, 1918, and up to and beyond February 1, 1919, and was not on or before that date in any wise abrogated or amended (R. V, 1859).

By joint Resolution of Congress passed on July 16, 1918 (40 Stat. at L. Part I, 904, Ch. 154), the President of the United States was authorized to take over the operations of telephone companies in the United States. On July 22, 1918, by proclamation, the Postmaster General was authorized to take over such operations as of midnight July 31, 1918 (40 Stat. at L., Part 2, p. 1807).

Self-Serving Declaration to Support 4½% Charge.

On July 31, 1918, the Executive Committee of the Chicago Company met. At this meeting,

> "The chairman stated that a letter had been received from the American Telephone and Telegraph Company dated July 17, 1918, re-stating in summarized form the obligations of that company to this company under the license contract. The letter was read by the secretary and was ordered spread upon the minutes of this meeting." (R. VI, 2080).

The letter was signed on behalf of the American Company by its Senior Vice-President and director, who was also a director of the Chicago Company and who, as we already have seen (R. VI, 2190) in 1912 made the secret salary agreement with the President of the Chicago Company. The letter was addressed to the latter as President of the Chicago Company. This letter said:

> "As you know, the original license contract held by your company has been modified in various particulars, both by letters and, less formally, by the acts of our respective companies under it, in a way and to an extent which very largely increases the obligations of this company under the contract.
>
> Some of the obligations of this Company not specifically mentioned in your Company's original license contract but in fact included in it and long since firmly established, which with the rental of instruments are covered by the 4½ per cent of your gross receipts you are now paying, are briefly outlined below. (R. VI, 2078).
>
> • • • • •
>
> As you also know, this Company has not failed on any occasion to recognize and live up to these obligations, and therefore, we are glad to restate them in order that they may become a part of your records."

All of the services which were enumerated, but one, were of the character of services rendered prior to 1896, which services the Courts in the Western Union litigation had

held were given by the American Company without any contractual obligations on the part of the licensees to make payment therefor* (*supra*, 168).

On August 1, 1918, the Postmaster General took over the "supervision, possession, control and operation" of the telephone properties of the United States, including the Bell System (R. VII, 2572 (35)). The American Company and the Associated Companies were represented in all dealings with the Postmaster General by the same Senior Vice-President who signed the above letter (R. V, 1592). The Contract with the Postmaster General provided that the license and contracts between the American Company and the licensee companies be continued** (R. VII, 2571 (33); Rec., Missouri Case, 118).

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*The services which were enumerated were: (a) legal and expert services in defense against infringement of patents through the use of the patents licensed by the American Company where such use is advised by the American Company; (b) the right to use when completed and standardized and as recommended by the American Company all new and improved telephone apparatus and developments in the art of telephony resulting from or through the efforts of the American Company; (c) the obligation of the American Company to maintain an organization to develop the art of telephony so as to relieve the Chicago Company from maintaining its own organization for that purpose; (d) the obligation of the American Company to make available such developments and inventions of others which the American Company has the right to use as recommended by the American Company for use; (e) the right to get advice from the American Company on all phases of the operations of the telephone business of the Chicago Company, through circulars, bulletins, special studies, or special work, if necessary or desirable in complicated matters; (f) the right to get advice from the American Company and assistance in financing its requirements for the extension, development and improvement of its telephone system, in securing funds on fair terms for new construction and other expenditures, in marketing its securities and in the general matter of its finances; (g) the right to the co-operation and support of the American Company in promoting the welfare work among its employees; (h) subject to the obligations of the parties under existing agreement between the parties as to the employees' benefit fund plans, the right to use the funds of the American Company to make up deficiencies under the Chicago Company's plan, and the obligation in the American Company to maintain its own fund at not less than the original amount; (i) the right to require the American Company to return for repair or replacement all defective telephone instruments and to procure the necessary parts to replace telephones in service or in stock (R. VI, 2079). The service, which did not exist in 1896, was the guaranty of the Employees Benefit Fund.

**The Contract with the Postmaster General is reproduced in the

Self-Serving Declaration Untrue.

The letter presented July 31, 1918, was a self-serving declaration, deliberately made to form a basis upon which the American Company could continue the 4½% charge to the Postmaster General in spite of the decision in the Peoria Rate Case. In the light of the historical survey of the period of 1876-1919 (*supra*, 149), it is of course obvious that the representations contained in the letter of July 17, 1918, were untrue insofar as they were intended to cover the contractual relations between the American and Chicago Companies. Probably nothing better indicates the true character of the letter than the representations therein made covering the financial services alleged to have been given to the Chicago Company pursuant to

> "The right to your (Chicago) Company to avail of this Company's (American Company) advice and assistance in the financing by your company of its requirements for the extension, development and improvement of its telephone system, in securing funds on fair terms for new construction and other expenditures, in marketing its securities, and in the general matter of its finances." (R. VI, 2079).

Missouri Case, 262 U. S. 276 (Rec. *Missouri Case*, 118-120). Section 44a thereof provides:

> "The American Company will continue to perform for the telephone properties of all the licensee companies of the Bell System the duties theretofore required of it under the license agreements, a specimen of which is hereto attached, which duties may be stated generally, as follows: (Then follows an enumeration of services of the identical character of those enumerated in the letter of July 17, 1918, discussed above in the text herein.)
>
> In consideration of the foregoing duties, the 4½ per cent payments heretofore made by the constituent companies to the American Company under said license agreements shall be continued."

The specimen copy attached was identical in form and substance to that of the 1919 Memorandum (excepting that the licensee was required to pay local taxes on the telephone instruments (Rec., Missouri Case, 130)). But the 1919 Memorandum was not presented to the Chicago Company until after the Armistice and was not effective prior to February 1, 1919 (*infra*, 200). The Chicago Company will argue that the 1919 Memorandum is based upon the contract with the Postmaster General although the latter contract was predicated upon the existence of such a contract prior thereto.

From the history we have already given, it is clear that whatever may have been the case in the balance of the Bell System, the Chicago Company had no right to demand and did not require, and the American Company had no obligation to render and did not render to it, any financial assistance whatsoever; that on the contrary, the Chicago Company rendered very valuable financial assistance to the American Company and to the Bell System; and that the financial assistance given by the American Company to the other companies of the Bell System had resulted in a rebate to them of all or part of their respective 4½% license payments, which rebate was not given or taken into account in making the 4½% charge to the Chicago Company.

THE REPRESENTATIONS IN THE LETTER OF JULY 17, 1918, AS TO THE SERVICES ALLEGED TO HAVE BEEN RENDERED TO THE CHICAGO COMPANY AND AS TO ITS ALLEGED AGREEMENT OF THE CHICAGO COMPANY TO PAY FOR ANY SUCH SERVICES WERE UNTRUE.

Execution of 1919 Memorandum.

We shall next consider the execution of the 1919 Memorandum which purported to restate the letter of July 17, 1918.

The Armistice was signed on November 11, 1918, and foreshadowed the return of the telephone properties to their owners (R. VII, 2586 (33)).

The contract itself dated as of February 1, 1919, was prepared by the legal department of the American Company (R. V, 1602; R. IV, 1196), was authorized on Nov. 27, 1918, by the Board of Directors of the Chicago Company (R. VI, 2163), and was signed, on behalf of the Chicago Company, by its President to whom was addressed the letter of July 17, 1918, and whose personal relationship to the

American Company we have already detailed (*supra,* 68). The provisions of the 1919 Memorandum relating to the long distance arrangement have been discussed (*supra,* 49). We will now discuss its other provisions.

1919 Arrangement for Services of American Company.

A. The 1919 Memorandum (1) *creates* the right in the Chicago Company to demand and the obligation in the American Company to supply the services (a) of rendering financial assistance and (b) of business management, incident to the efficient ordinary operation of its local public utility functions in its territory; and (2) *reaffirms* the right in the former to demand and the obligation of the latter to supply the services (a) of rental of telephone instruments and (b) of making available inventions and improvements in manufactured apparatus.

B. The 1919 Memorandum adopts the percentage of gross operating revenue of the Chicago Company theretofore used as a measure of cash rental or royalty for the use of telephone instruments as the perpetual charge for that use plus the perpetual charge for the newly created services of rendering financial assistance and of business management plus the perpetual charge for the service of making available improved apparatus (over and above the purchase price paid to the Western Electric for such apparatus).*

*The 1919 Memorandum makes two vital changes in the Original License Contract of 1881: (1) it provides that all rights not specifically granted to the Chicago Company remain with the American Company. This substitutes the provision of the original standard license contract for the provision of the Original License Contract of 1881 that the Chicago Company shall enjoy all the rights which the American Bell itself had within the territory designated by the contract; (2) it substitutes the provision of the original standard license contract prohibiting assignment by the lessee and permitting assignment with release from further obligations by the lessor (*supra,* 159) for the rights of assignment in the Chicago Company and for the continued obligation of the American Company to perform thereunder even after the latter's assignment and transfer of title to telephone instruments (*supra,* 160).

B.

The rights of the Chicago Company and obligations of the American Company created and affirmed by the 1919 Arrangement are unenforcible.

The obligations of the Chicago Company to make payment to the American Company under the 1919 Memorandum other than for the rental of telephone instruments, is supported neither by the enforcible promise of the American Company to perform in the future; nor by the certainty of actual performance by the American Company in the future.

1. *Section 9.*

(a) The right of the Chicago Company under subsection (a) of Section 9 (R. IV, 1206) to the use of telephonic devices and apparatus, and of methods covered by patents or licenses owned or to be owned by the American Company, is contingent upon the willingness of the experts of the American Company to recommend the use thereof to the Chicago Company, and is contingent upon their opinion that such patents are advantageous and practically useful.

(b) The right of the Chicago Company under subsection (b) of Section 9 (R. IV, 1206) to demand the continued prosecution by the American Company of investigations "designed to promote safety, economy and efficiency in the equipment, construction and operation of telephone plants" is contingent upon such equipment, construction, and operation being safe, economical, and efficient to all licensee companies and not only upon its being safe, economical, and efficient for the plant of the Chicago Company.

(c) The right of the Chicago Company under subsection (d) of Section 9 (R. IV, 1207) to demand aid from the

American Company in securing funds is contingent upon the condition of the finances and credit of the American Company. The American Company is the sole judge of its condition.

(d) The right of the Chicago Company under the same subsection to demand the necessary financial support and assistance, is contingent upon such support and assistance serving the best interests of the American Company as well as of the Chicago Company. The American Company is the sole judge as to whether its interests will be best served by such requested financial support and assistance.

(e) The right of the Chicago Company under the same sub-section (d) of Section 9 to the use of telephonic appliances under inventions and patents belonging to others than the American Company is contingent upon the American Company's judgment as to whether it considers as reasonable the terms upon which it will acquire such patents and apparatus from such others; also upon its judgment as to whether the terms upon which the products can be manufactured from such inventions are reasonable.

(f) The right of the Chicago Company under the same subsection, to protection and defense against infringements on patented articles, is applicable only to such apparatus, methods, or systems as the American Company may recommend. It is solely within the power of the American Company to recommend.

(g) The right of the Chicago Company under subsection (f) of Section 9 (R. IV, 1208) to demand the active assistance, cooperation, and support of the American Company in connection with the adoption of any measures for the protection, preservation, health, and well-being of the employees of the Chicago Company, and of the conservation of its high quality of service to the public through the maintenance of a stable and contented personnel, is contingent

upon the judgment of the American Company as to whether such measure will accomplish the purpose intended by the Chicago Company.

2. *Section 9 (a)*

The right of the Chicago Company to extend to its connecting companies within its territory the benefits of the services rendered to it by the American Company is contingent upon the American Company's performance to the Chicago Company, which in turn is illusory for the reasons above stated (R. IV, 1206).

3. *Section 9 (f)*

The right of the Chicago Company to participate in the guarantee to protect the Employees' Benefit Plan is contingent upon the judgment of the American Company that such participation will not impair the rights of other licensee companies to participate in the same fund (R. VI, 2001).

4. *Section 13.*

Section 13 (R. IV, 1214), provides:

> "If the licensor shall transfer to any party who shall agree to perform the stipulations hereof, its title to the telephones furnished and licensed hereunder and the patent rights under which they are licensed, and its then existing rights hereunder, the provisions hereof shall inure to the benefit of and be binding upon such party in respect of all things done or to be done after such assignment, as if it were named a party hereto, and the Licensor shall no longer be responsible hereunder."

(a) Under this section, the American Company would be released even though the assignee were not financially able to carry out its obligations under the 1919 Memorandum.

(b) The American Company does not obligate itself to assign to such assignee its patents and exclusive licenses to apparatus. The assignee could not, therefore, carry out the provisions of the 1919 Memorandum covering the use of apparatus (Sec. 4; 9a). This provision is especially obnoxious in view of the following: If the American Company does assign the patents, the provisions of the contract "inure to the benefit" of the assignee. Among these provisions is Section 8 (R. IV, 1205), under which the licensee "admits the validity of all patents relating to telephony and telephonic appliances now or hereafter held by the licensor or under which it may hold licenses exclusive in their character * * *." This sort of undertaking has been condemned in the case of *United States of America v. Standard Oil Co. of Indiana, et al.* (33 Fed. (2d) 617) on grounds of public policy. It is especially vicious when by virtue of Section 13 it can be availed of in perpetuity by some irresponsible assignee owner of all the cat-and-dog patents in the art.

(c) The promise of the American Company to render financial assistance is predicated upon the conditions of its own finances and credit (R. IV, 1207). There is no obligation on the American Company to provide an assignee whose finances and credit are as sound as those of the American Company.

(d) There is no obligation on the American Company to assign to its assignee the rights which it enjoyed under the license contracts with the Bell licensee companies to enable the assignee to carry out the provisions of the 1919 Memorandum relating to the use of the facilities of Bell licensee companies in long distance service to points within their respective territories (Sec. 10 (c)).

(e) There is no provision requiring the American Company to make available to the assignee the use of its own

facilities to permit such assignee to carry out the provisions in the 1919 Memorandum relating to obligations of the operator of long distance service within and without the territory of the Chicago Company.

All of the obligations of the American Company under the 1919 Memorandum other than the rental of the instruments and all of the rights of the Chicago Company to receive the benefits therefrom, constitute a clevis binding the two parties, but with the clevis pin in the exclusive control of the American Company.

C.

The 1919 Arrangement is not such an Act of Management as should be sanctioned.

Summary Statement.

The directors of the Chicago Company, acting as ordinary business men, should have rejected the 1919 Arrangement because:

1. *Services Embodied in Patented and Non-Patented Apparatus and in Rental of Telephone Instruments.*

No machinery is provided by the 1919 Memorandum whereby it can be definitely ascertained that insofar as the percentage of operating revenues is intended to cover the services of rental of instruments and of making available inventions and improvements embodied in patented and non-patented apparatus, such compensation does not exceed the sum of the maximum compensation permitted by previous existing contracts to be paid to the American Company for each one of such services.

Therefore, as to these services, it is not possible to effect a bilateral arrangement of the character of the 1919 Arrangement. Its binding force as a bilateral undertaking must therefore be determined upon its relation to the promise of the American Company to supply the other service of rendering financial assistance and business management.

2. *Financing Service.*

Financing service in the form of financial assistance may by one of several kinds:* (a) assistance through the purchase of stock by the American Company either as stockholder or as underwriter. Since 1914 the Public Utilities Commission has regulated the minimum price of sale (Illinois Laws of 1913, Sec. 21, 470). The American Company would have to pay above that price to be of special service to the Chicago Company. This it has never done, excepting for the possible premium paid of $3,500 (R. V, 1608). The yield on the Chicago Company stock of 8%, plus its financial history, is conclusive against any arrangement for it to pay a yearly charge to be assured of a banker (assuming that the 1919 Memorandum constituted the American Company an underwriter, which it did not) (R. V, 1860); (b) assistance through the purchase of funded obligations. Apart from the fact that the financial history of the Chicago Company does not warrant any such arrangement, the infrequency of such issues is conclusive against any yearly charge for the assurance to have a purchaser thereof; (c) assistance through the advances for temporary needs. The financial history of the Chicago

*We do not discuss herein the financing service which consists of giving the Chicago Company as a department of the Bell System the benefit of the pooling plan of financing the system as a unit. The benefits from that service can be reflected only if the adequacy of the Chicago Company's net earnings is tested by the special standard of the Bell System and not by that of independent enterprises (*infra*, 373). In the text we discuss the service from the viewpoint adopted by the Statutory Court that the financing service is to the Chicago Company as an independent enterprise.

Company from 1881 to 1918 shows that the Chicago Company borrowed little, if anything, from the American Company (R. VI, 2097) and that its credit at banks, even in war times, was sufficient, and that loans were made to it at lower interest rates than those charged by the American Company (R. VI, 2108). A yearly charge to the American Company, as a substitute banker, was, therefore, not sound business; (d) the assistance through the payment of a higher rate of interest on current balances (R. V, 1810). This may be dismissed as being merely a trading of dollars, for which no yearly charge should be made in advance; (e) assistance through the purchase of stock not subscribed for by other stockholders (R. V, 1612). This may be dismissed as illusory in view of the fact that less than 1.7% of stock was outstanding with others than the American Company (R. VI, 1982). Moreover, the financial history of the Chicago Company since 1881 shows that such service was neither required nor given by the American Company;* (f) assistance through advice. It is the function of directors to determine the financial policy of their company. The American Company, as principal stockholder, represented by eight directors who hold its stock as qualifying stock, would naturally participate in such determination. But no law gives the right to a stockholder to make a yearly charge for providing directors who will decide the financial policy of their corporation. The

*During the first ten years after the organization of the Chicago Company, the American Company did not subscribe for its own pro rata portion of increases of stock but reduced its percentage of stock holdings from 50.7% in 1881 to 37% in 1890. It then increased its percentage of stock holdings in 1891-1893 at par when the stock was paying cash dividends at the rate of 24%, 20% and 12% respectively (R. V, 1860; R. VI, 1982). It further increased its stock holdings in 1900 at par, when the open market price of the same stock ranged from $180 to $245 per share; in 1902, at par when the open market price ranged from a low of $118 to a high of $276 per share; in 1907, at par, when the open market price ranged from a low of $95 to a high of $134.50, but which stock paid not only a 10% cash dividend but a 25% stock dividend in the following year; in 1916, when it purchased 810 shares at par plus an aggregate premium of $2,486.25; and in 1917, 338 shares at par plus an aggregate premium of $545. (R. VI, 1982; R. VI, 2120; R. VI, 2275.)

three independent directors giving the same kind of advice received no compensation therefor. Advice other than that coming from the directors was not needed by the Chicago Company.* It was not in the condition of the Southwestern Bell in 1889. The latter's license contract prohibited financing without the consent of the American Bell (Appendix, 5). Where the licensee's credit was weak, the increase of its indebtedness might impair the equity of the stock acquired by the American Company and might force the American Company to advance money, which it expressly did not want to do (Appendix, 5). The Chicago Company has never over-extended itself in fact. Since 1914 the Public Utilities Act guards against over-extension in indebtedness (Appendix, 5; Illinois Laws of 1913, Sec. 21, 470).

The financing service in the form of financial assistance was not required by the Chicago Company on a basis of a contracting in advance therefor.**

The binding force of the 1919 Memorandum as a bilateral contract must be determined upon the basis of excluding financing service from the services covered by the promise to pay a percentage of gross revenue.

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*From the early days it had influential and efficient management (R. VII, 2356 (2-3)] Its financial assistance in the early days was the backbone of the Bell System (*supra*, 164). To the efficient management of the Chicago Company was attributed the early success of the Bell System (R. VII, 2356 (2-3)).

**But that was not true in the case of some of the other Bell licensees who contracted for such service. They needed the assurance of a banker and did receive substantial benefits from it. Note the experience of the Southwestern Bell, the Missouri Company, the Central Union and the Michigan Company (*supra*, 189). In fact, that financial service formed the backbone for their payment and, as we shall see, that service is often relied on by the courts and commissions to support the 4½% arrangement.

3. *Service of Business Management.*

(a) There is no assurance of a continuity of management by the American Company.

By supplying the service of business management incident to ordinary operation of the public utility functions of the Chicago Company, the 1919 Memorandum covers the arrangement which the parties themselves contemplated—*i. e.*, that of the American Company "relieving the separated operating companies from the obligation of maintaining anything but an operating organization" (R. VII, 2525 (45, 46); R. III, 1074 (*infra*, 259)).

The minimum precaution to be taken by the directors was to make sure that in any event there would be a continuity of the business management by a party capable of performing the service; otherwise the Chicago Company might find itself without any departments other than an operating organization and with no party capable of supplying the services in lieu thereof. For the reasons already stated (*supra*, 202) there was no certainty of any such continuity of management.

(b) The charge for the service of business management bears no relation to the costs of the service rendered nor to any measurable standard by which its fairness may be tested.

The business management of a corporation is performed by persons who are paid salaries to devote their time and energies for the benefit of their employer in every way possible. The American Company is merely the contractor who agrees to provide the management—*i. e.*, the persons. If the business management contract is justifiable at all, it can be supported only by a promise on the part of the Company under management to reimburse the actual ex-

pense of employment plus a fair charge for the service of procuring the personnel and for supervision. Such a business management contract is the one which the two companies made to cover the services of the Chicago Company in employing and supervising the personnel who operate the long lines plant in Chicago (R. VI, 1966). There is nothing distinctive in the business management service of the American Company which would justify the establishment of a contractual charge by it on the basis of a participation in the gross revenues of the Chicago Company, where the participation itself bears no relation whatsoever to the cost of the business management service rendered or to the net profits of the Chicago Company resulting therefrom, and where no measurable standard has been provided by which the fairness of such contractual charge can be tested. Certainly the Chicago Company, if it retained these departments, could not legally establish their expenses on any such basis. Can it do indirectly what it can not do directly through the simple device of turning over the management of such departments to another company? The question answers itself.

True, the identical basis of charge has been before this court in other cases, including the *Missouri* case (262 U. S. 276) and the *Houston* case (259 U. S. 318). But there in an essential difference *in fact* in the instant case which renders their authority inapplicable. In these cases, as in the instant case, the portion of the charge allocable to the service of rental of instruments is made to bear relation to the cost or benefit of the service rendered, either standard of which is readily and definitely measurable. (*Houston* Case, 259 U. S. 318, 323; (*infra*, 342); Rec. *Houston* Case, 335.) In the two cases before this Court the entire balance of the 4½% payment is made to bear relation to, and its fairness is tested by, the cost for or benefit derived from one or both

of the services of financial assistance and/or of making available improved apparatus, either standard of which is readily and definitely measurable (*infra*, 242, 249).

In the two Bell cases before this court the issue of the propriety and fairness of the basis of charge and of the amount of payment for the service of business management was a moot one.

In the instant case, the financing service in the form of financial assistance is at best so negligible that admittedly the Chicago Company does not use it to support the 4½% charge. In the instant case, for the reasons already given, only such portion of the 4½% charge can be made to bear relation to, and be supported by, the service of making available improved apparatus, as comes within the margin of differential in favor of the Western Electric prices charged to the Chicago Company for such apparatus. Unless, therefore, the entire balance of the 4½% charge, after deduction of the charge for rental of instruments, is absorbed by such margin, the surplus payment must bear relation to the service of business management. Indeed, because of the negligible amount of any margin in favor of Western Electric prices charged to the Chicago Company for improved apparatus, only a very negligible portion of the payment can be supported by the service of making available improved apparatus. On the basis of the record not over $32,000 could be charged (*infra*, 295). Therefore the entire 4½% charge after deduction of the charge for rental of instruments must then bear relation to, and be supported by, the service of business management only. In the instant case, unlike the other cases, there is the issue of the propriety of establishing a charge for the service of business management based upon a participation in gross revenues where such participation bears no relation whatsoever to the cost of the service rendered or to the benefit

derived therefrom, and where no other measurable standard has been established by which the charge can be tested. We have found no case to support a charge of such service on that basis where on the record the issue is not moot.* For the reasons already stated, a charge established on such a basis should not be sanctioned.

The 1919 Memorandum is not such an Act of Management as should be sanctioned.

D.

The compliance with the procedural requirements of the Illinois Public Utilities Act necessary as a condition precedent to making the 1919 Arrangement legally effective, was not made.

We have already discussed the validity of the 1919 Memorandum insofar as it relates to Toll Service (*supra,* 57). We now desire to discuss the provisions relating to the 4½% payment.

The 1919 Memorandum was made effective without the consent and approval of the Public Utilities Commission being procured and was not filed with the Commission before or after its execution or its effective date (R. V. 1785).

Section 27 Violated.

Without the consent of the Commission, "no public utility may assign, transfer, lease, or otherwise dispose of or encumber the whole or any part of its franchise, licenses, permits, plants, equipment, business or other property" necessary or useful in the performance of its duties to the public (Section 27 (a), Appendix, 63), nor may such public

*The American Company itself provided the machinery to give the Chicago Company the benefit of the part of the charge which proves not to have been needed in lieu of making a strict accounting therefor (*infra,* 367).

utility "by any means, direct or indirect, merge or consolidate its franchises, licenses, permits, plants, equipment, business or other property with that of any other public utility" (Section 27 (b), Appendix, 63); nor may any contract be made by such utility with reference to or affecting the "franchise, license, permit or right to own, operate, manage or control any public utility" (Section 29) (Appendix, 65).

The 1919 Memorandum, providing for the taking over of all but one of the departments of the Chicago Company (*supra,* 210), is an agreement affecting the right of the latter to manage and to operate a utility within the scope of Section 29; is a transfer of part of the franchise, license permit and business of the Chicago Company within the scope of Section 27 (c) (Appendix, 63); and is an indirect means to merge or consolidate its franchise, license and permit with that of other utilities within the scope of Section 27 (d) (Appendix, 63). The Commission not having consented to its execution, the 1919 Memorandum is void.

Sections 8, 9 *and* 15 *Violated.*

Under Section 8 (R. I, 70) the Commission has jurisdiction to inquire into the management of the business of the Chicago Company. Section 9, (R. I. 71) provides that each utility furnish the Commission all information required by it to carry into effect the provisions of the Public Utilities Act, and for that purpose to furnish all books, accounts and papers relating to its property or affecting its business. Section 15 (R. I, 76) requires each utility to allocate all expenditures into accounts in the manner prescribed by the Commission, in which the latter may provide for the examination and audit of all accounts. The 1919 Memorandum has merged the operation of and the costs and expenses of all of its departments but one

with those of all the corresponding departments of all the other licensees in the Bell System who are outside the jurisdiction of the Commission. By so doing, the parties have made it impossible for the Commission to carry out its powers under Section 8: they have incapacitated the Chicago Company to furnish the Commission the costs and expenses of the transferred departments of its business as required by Section 9: they have deprived the Commission of any power of examining the costs and expenses of all departments other than the operating organization upon the basis of actual costs and expenses, and have compelled it to accept the charge determined upon a contract basis.

Section 13 Violated.

Section 13 (R. I, 76) provides for a system of accounts "distinguishing all payments for operating expenses from those for new construction, extensions and additions." Account No. 527 of the Uniform System of Accounts in force in Illinois (R. II, 748) provides:

> "When a telephone company is granted by another telephone Company the use of its patents, or is furnished instruments and equipment and general supervision under an agreement for apportioning the revenues of the licensee, the proportion accruing to the licensor should be included by the licensee in this account."

This account, being a deduction from revenues and therefore having the effect of being an expense account and not a capital account, cannot legally include any items which in fact are not expense items. Instruction No. 6 of the Uniform System of Accounts provides that "in no case should discount on capital stock be charged to or included in any account as part of the cost of acquiring property, tangible or intangible, or as part of the cost of operation" (R. IV, 1186). Instruction No. 7 provides that "no discount and expense on funded debt should be charged to or included

in any account as part of the cost of acquiring any property, tangible or intangible, or as a part of the cost of operation" (R. IV, 1189).* That part of the 4½% charge which covers service to be rendered other than the financing of the Chicago Company is an operating expense. So much of the 4½% payment as represents the financing of the Chicago Company through the purchase of capital stock is neither an operating expense nor is it chargeable to the capital account. So much of the 4½% payment as covers the financing through the purchase of funded credit obligations is a discount and cannot be treated as a current operating expense. The combining of these various items of operating expense and of capital account, without the possibility of their separation, renders it impossible for the Chicago Company to maintain its accounts in the manner required by Section 13. The 1919 Arrangement is, therefore, void.

E.

The 1919 Arrangement violates substantive law.

Section 6 of the Corporation Act of Illinois in force in 1918 (Hurd's Illinois Revised Statutes 1917, Ch. 32, Sec. 6) requires the directors to exercise the corporate power of the Chicago Company. The corporate powers of the Chicago Company are:

> "To manufacture telephones and all apparatus connected therewith, and to construct, acquire by lease or otherwise, own and operate, telephones and telephone and telegraph lines and offices, and to lease the same, and to do a telephone, telegraph and district telegraph business" (R. V, 1860).

For the Chicago Company to carry out its express corporate powers of doing a general telephone business, it must

*The only exception to the above requirement is interest accruing during any construction period.

have absolute control over each and all of the departments of its business, and its directors must have the control of, and the ability to exercise discretion with reference to the functioning of, each and all of the departments of the Chicago Company. The 1919 Memorandum (as interpreted by the parties) deprives the Chicago Company and its directors of these powers as to each and all of the departments other than the operating division and is therefore void.

The 4½% arrangement prescribed by the 1919 Memorandum has no binding effect as a Bilateral Undertaking.*

DISCUSSION AS TO CONTENTION NUMBERED II.

II.

THE MAXIMUM CHARGE TO OPERATING EXPENSE IN 1923 SHOULD BE $709,000, REPRESENTED BY THE CHARGE ALLOCATED BY THE CHICAGO COMPANY TO COVER THE RENTAL OF THE TELEPHONE INSTRUMENTS. THE EXCESSIVE CHARGE TO OPERATING EXPENSES IN 1923 WAS $1,015,243.

The Chicago Company in 1923 charged to operating expense the entire payment of $1,724,243 required under the 1919 Arrangement. The Chicago Company had to justify the payment upon the basis of the nature and value of the service rendered upon some measurable basis. In so doing, it apportioned $709,000 as the fair rental for telephone instruments in service (R. III, 1038) and $1,015,243 as fair compensation for other services rendered during the year 1923. The Statutory Court erroneously stated the amount

*Thus far we have not considered the effect on the Arrangement of the legal consequences arising from the conclusion—that the Chicago Company has been reduced to a mere agency or instrumentality of the American Company. The effect of that conclusion is discussed herein (*infra*, 276).

of rental as $874,243 and the payment for other services as $850,000 (R. I, 190). Why it should increase rentals by $165,000 above the amount charged therefor by the Chicago Company, and hold such rentals fair, and why it should consider the fairness of the payment for the other services upon the basis of a payment of $165,000 less than the amount charged therefor by the Chicago Company, is not stated in the Opinion. In the discussion herein we have used the amounts actually charged by the Chicago Company for each class of services.

A.

The payment of $709,000 allocated to rental for instruments is excessive by $120,000.

The Chicago Company calculated the annual fair rental to be paid by it for the use of telephone instruments by using the reproduction cost of telephone instruments in service, if purchased in 1923 by non-licensee telephone companies, and then applying thereto percentages to cover the expense of depreciation, taxes, insurance and return on investment. After so doing, it related the number of instruments in service in Chicago and in reserve, to the number of stations in service in Chicago, and multiplied the annual charge per station by such number of stations. For 1923 the Chicago Company calculated the fair annual charge to be $1.07 per station, based upon a return of 8% and on investment, and the fair rental to the American Company to be $709,000 (R. III, 1037-8).

The American Company paid $3.23 per set in 1923 (R. III, 1126) instead of $4.50 per set as paid by non-licensee telephone companies and as used by the Chicago Company in its calculations (R. III, 1037). The 8% net return on $4.50 per set represents a yield to the American Company of

11.3% on its reproduction cost of sets before depreciation. But the net rental paid by the American Company to the Chicago Company on the long lines plant is only 6% on the reproduction cost of that property before depreciation (*supra*, 124). Either the American Company's rental paid to the Chicago Company is 40% too low or the Chicago Company's rental paid to the American Company is 90% too high. There is no reason for any such preferential treatment in the rental of property. If the yield to the American Company is adjusted to the yield to the Chicago Company, the excessive amount included in 1923 in the charges for rental of instruments is at least $120,000.*

B.

No financial assistance from the American Company was required by or was given to the Chicago Company in 1923 or at any time during the entire period of their relationship prior thereto or at any time thereafter during the period under investigation.

1. Financial Assistance of American Company.

(a) *Discounts on Purchases of Stock Illegal.*

The Chicago and American Companies claim that part of the financial service of the latter consists in supplying funds to the Chicago Company through the subscription to its stock at par as it was offered to stockholders (R. V, 1831; R. V, 1600). Such part of the 4½% payment as covered such services was illegal.

In each of the years 1921, 1922 and 1923, the Illinois Commerce Commission authorized the Chicago Company

*The cost to the American Company was 70.77% of the price used by the Chicago Company in its calculations. The 5.33% difference in yield on investments by the two companies applied to 70.77% of the valuation of $3,114,286 for instruments as found by the Chicago Company totals—$120,000 (R. III, 1037).

"to issue and sell at not less than par to its stockholders pro rata to their several holdings" $10,000,000 par amount of stock. Immediately after each Order was issued, the American Company made application to, and was authorized by the same Commission to purchase, at "not less than par," its pro rata share of such authorized stock. Neither the applications of either company nor the Order in each case provided for any compensation, allowance or bonus to the American Company for purchasing such stock at par. The Chicago Company is by statute prohibited from disposing of its stock "on any terms less favorable than those specified" in the Order authorizing the sale of the stock (Section 21, R. I, 81). The stock allocated to the Chicago Exchange in 1923 totaled $5,500,000, and in the five-year period $27,500,000, par value of stock (R. V, 1859); of which stock the American Company purchased at least 98% (R. VI, 1982).

No adequate defense has been offered for this illegal charge. Contention was made in behalf of the American Company that the service consisted in holding funds available to ~~the~~ subscribe and in making preparations for so holding them from time to time when the budget of the Chicago Company was presented showing the need for funds during the ensuing year until the funds were paid over for the stock (R. V, 1816, 1819, 1820, 1830, 1831). Such a position is clearly untenable. The expense incurred by stockholders to enable them to subscribe to new issues of stock is not chargeable to the issuing corporation.

The contention that the American Company had the obligation as well as the right to subscribe for its pro rata share of stock is clearly untenable. The obligation of the American Company is not absolute (R. V, 1611, 1612). And even if it were, the payment is in the nature of an underwriter's discount, clearly in violation of the Orders authorizing the sale of the stock.

The contention is made by the Chicago Company that the financial service by the American Company consisted in purchasing "those shares which were not taken by stockholders who were entitled to subscribe for them" (R. V, 1612). The record shows an increase of but one-half of one per cent in the percentage of holdings by the American Company from 1918, when the 1919 Memorandum was approved, to 1925 (R. VI, 1982), and a maximum increase in percentage of holdings during those seven years of but 2,000 shares of the par value of $200,000 (R. VI, 1982; R. V, 1859).* The premium on all subscriptions by all stockholders, including the American Company, during the seven years, was $522 (City Ex. 80, opposite R. VI, 2120).

Nor is the contention sound that the Chicago Company required and received any financial service in the sale of its stock to the American Company. The record of the yield on the credit obligations of the two companies issued in 1923 should have justified a sale of the stock of the Chicago Company to the American Company on the basis of a yield lower than the yield which the latter received (R. VI, 2160) (*infra*, 348).

Upon the facts in the record no charge was warranted and under the law no charge was legal for the service of the American Company in purchasing as stockholder its pro rata portion of the stock of the Chicago Company as and when the stock was offered to all stockholders. Such portion of the $1,015,243 payment as covers this service is clearly illegal.

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*The service rendered by the American Company in connection with the pooling arrangement under which capital is provided for the Bell System, is not considered here. To reflect that service the standard of the Bell System for adequate returns must be adopted which is discussed (*infra*, 373).

(b) *Alleged Service of Providing Advances for Current Needs Illusory.*

The benefits received by the Chicago Company from the American Company through advances or purchases of the former's credit obligations were negligible and were offset by advances made by the Chicago Company (R. VI, 2097, 2102, 2098).

(c) *Alleged Service of Being in Readiness to Finance Illusory.*

The American Company has offered a unique reason for claiming benefits through advances. It has claimed that the Chicago Company presents its budget in October or November of one year for the following year's requirements. The American Company holds current balances in its treasury to meet these entire requirements. Therefore, the Chicago Company is receiving the benefit of the entire amount required according to its budget for the full period of the budget (R. V, 1819-20). We can hardly conceive of a more fantastic projection into the realms of high finance. Of course, the American Company would not consider that most of these funds go to purchase stock under the conditions already described (R. V, 1824; *supra*, 207); that it is inconceivable that a company of the financial standing of the Chicago Company should need a year's protection on its current operations; that it is contrary to all elementary business principles to have funds lying idle for a full year to take care of budgetary demands. On the one hand, the American Company claims credit for making it unnecessary for the licensees to finance in advance of requirements; on the other hand, it claims credit for financing the licensees in advance of requirements (R. V, 1826).

2. THE CHICAGO COMPANY RENDERED VALUABLE FINANCIAL ASSISTANCE TO THE AMERICAN COMPANY.

Contrast the alleged services by the American Company for which a charge is demanded with the following financial assistance given by the Chicago Company for which no charge is made to the American Company!

(a) *Central Union Purchase.*

We shall first state the facts from admitted evidence and then state the additional evidence offered by the City but refused admission by the Statutory Court.

Admitted Evidence.

We have noted above the fact that in 1913 Receivers were appointed for the Central Union properties; that at the date of the receivership there was owing to the American Company at least $12,000,000 principal amount of indebtedness, covered by 59 notes of different dates of issue, ranging as far back as 1905; that the American Company sold them to and re-purchased them from the Chicago Company (R. VI, 2104, 2105; R. V, 1606). In the course of the receivership, the American Company also agreed to hold in suspense the 4½% license payment currently due to it under the Central Union License contract (R. VI, 2125).

In 1919 the litigation was settled and the receivership was terminated (R. VII, 2580 (10)). The amount of principal indebtedness due to the American Company, represented by notes, had not been reduced, and over $10,000,000 in interest had accumulated to the end of 1919 (R. VII, 2594, (48) 2598 (64)).

During the year 1920 the American Company effected a

reorganization of the properties of the Central Union in the following manner as described by it:

> "In the early part of 1920, to meet statutory requirements in respect of telephone companies operating in Indiana, and in an endeavor to secure improvement in operating results, it was deemed desirable to form a new company—the Indiana Bell Telephone Company—to acquire the Central Union and other Bell System property in Indiana, the operations of the company to be confined to that state. This was done in March, 1920, the Central Union Company selling its property in Indiana to the newly incorporated Indiana Bell Telephone Company.
>
> * * * * * *
>
> With the territory of the Indiana Bell Telephone Company thus interposed between the remaining properties of the Central Union Company in Illinois and Ohio, it *followed that the most economical and efficient operation of the Central Union properties would be secured by their sale to, and operation as a part of the system of, other associated companies operating in Illinois and Ohio.* (Italics ours.) At the same time, this procedure was deemed to be more satisfactory to the regulatory commissions in these states, and to ourselves, by reducing the number of associated companies operating in these states. Arrangements were accordingly made whereby the Illinois property of the Central Union Company was sold to the Illinois Bell Telephone Company as of December 1, 1920. In payment for its property the Central Union Company accepted the notes of the Illinois Bell Telephone Company maturing in December, 1923. * * * The American Telephone and Telegraph Company purchased the notes and the additional capital stock issued by The Ohio Bell Telephone Company to enable the latter to buy the Ohio property of the Central Union Company, and from the proceeds of the sale the Central Union Company liquidated indebtedness to the American Company of like amount. The Central Union Company by these transactions sold all of its telephone property, but continues to own assets which consist mainly of securities of other companies" (R. VII, 2608, 2609 (29, 31)).

The purchase price by the Chicago Company of $15,500,000 in notes matured in 1923, when the mortgage indebtedness on its own property likewise matured. The notes were paid off in cash in 1923 out of the proceeds of its new and refunding bond issue of $50,000,000 (R. V, 1610; R. VII, 2609 (32)). The transfer to the Chicago Company of the title to the Central Union properties was a paper transfer insofar as the American Company was concerned, as it owned 99% of the stock of both companies (R. VI, 1982, 2283).

Rejected Evidence.

As bearing upon the real nature of the assistance to the American Company rendered by the Chicago Company in purchasing the Central Union property, and upon the extent of the benefit to the American Company therefrom, the City offered, but the Statutory Court refused to admit in evidence or to consider, City of Chicago's Exhibits 157, 157-A, 157-B, 157-C, 157-D, 157-E, 157-F, 157-G, 157-H, 157-I and 157-J (R. I, 578-596), all of which exhibits were prepared by the American Company at the request of the City. These exhibits show: In 1913 there was owing to the American Company from the Central Union $34,303,000 (R. I, 585). The Central Union then had outstanding $5,450,000 capital stock, against which there was an impairment of capital account in the amount of $4,600,000. During the period of the receivership, from 1914 to 1919, its properties were operated at a loss (R. I, 578), and by April 30, 1919, the impairment of its capital account had increased to $11,900,000, and by December 31, 1919, to $13,990,000. On the latter date the American Company owned $5,400,000 of capital stock, all of which had been wiped out (R. I, 580), and held $56,117,000 credit obligation (R. I, 596). The sales price in 1920 of

the Central Union properties to the three Associated Companies, including the Chicago Company, was sufficient to pay off the entire indebtedness to the American Company in the amount of $60,472,000 (R. I, 596), and sufficient to restore its entire capital account at $100 a share for 54,000 shares, and to create a surplus of $1,360,000 (R. I, 594). The sale to the Chicago Company resulted in a reduction in the capital deficit of the Central Union in the amount of $3,700,000 (R. I, 590), and liquidated $13,800,000* of indebtedness to the American Company.

This rejected evidence was clearly admissible for the following purposes:

It clearly shows that in paying off the purchase money obligations in 1923, the Chicago Company rendered a financial service to the American Company during the period under investigation which was greater than any possible financial services which the American Company could or did render during that period to the Chicago Company. Such financial service by the Chicago Company consisted of: (a) using its credit to liquidate to the American Company long past due indebtedness and accumulated interest from the Central Union which had been impaired and which could not be liquidated upon the credit of the latter company; (b) using the credit of the Chicago Company to permit the American Company to withdraw in cash more than the entire amount of its capital investment in the Central Union properties transferred to the Chicago Company, which prior thereto had been wiped out, and on which it had not received any return for many years. But although the American Company withdrew its capital investment, it still retained the same interest in the future earnings of the

*The $15,500,000 purchase price supplied about one-fourth of the capital and surplus of $6,810,000 created by the sale of all the Central Union properties, on the basis of the relative prices paid for the Illinois, Indiana and Ohio properties (City Ex. 158 F. G. H. I.; R. I. 588-595).

properties conveyed to the Chicago Company through its ownership of 99% of the stock of the Chicago Company. On the other hand, the American Company did not withdraw its capital investment in the properties sold to the Indiana Bell Telephone Company and to the Ohio Bell Telephone Company, as it took stock from them for part of the purchase price (R. VII, 2608-9 (29, 31)). During the first few years after the purchase, the Indiana Bell paid neither interest nor dividends on its credit or capital obligations (R. V, 1815-16); and (c) using the credit of the Chicago Company to finance thereafter the Central Union properties conveyed to it in lieu of using the credit of the American Company, theretofore for many years the sole credit used for that purpose. The exclusion of this evidence by the Statutory Court was prejudicial error (Assignment or Error No. 64; R. I, 211).

(b) *Chicago Company's Assistance to American Company in Sale of American Company's Stock.*

(1) Sales of American Company stock to public.

Since its organization in 1921 the Bell Telephone Securities Company has used the Associated Companies and their employees to disseminate information to local telephone customers regarding the American Company stock (R. V, 1814-15). The Chicago Company and its employees participate in these activities without charge and without reimbursement for the time used or expenses incurred therein (R. V, 1815). No contract exists between the Bell Telephone Securities Company and the Chicago Company covering this matter, but apparently the ability of the American Company to dominate and control both companies has, in fact, been exercised by it to bring about this arrangement. On the estimate of the American Company there were, in 1923,

"over a million conferences about the stock of the American Company between telephone customers and employees of the Associated Companies" (R. VII, 2650 (16)). Since the first part of 1923, these employees solicited sales of stock through conferences with telephone customers and with "individuals of modest or small means, many of whom apparently are relatively unacquainted with investments, know little about how to make investments, and have limited banking connections" and who "are not normally reached by established investment agencies" (R. VII, 2650 (16)). The stock was sold by the employees either for cash or monthly payments. Sales were daily reported by an officer of the local company to the Securities Company (R. VII, 2650 (16)). But why a subsidiary of the American Company should have the free use of the Chicago Company's entire operating organization as its stock selling agency, and the benefit of the Chicago Company's offices and of its accessibility to over six hundred thousand exchange customers for the use and benefit of the American Company, has not been explained. There is nothing in the record to show that the Chicago Company has taken any step to determine the cost to it of this service, nor the benefit thereof to the American Company. Its failure so to act is in violent contrast to its effort to find evidence to support the financing charge by the American Company already described. It is difficult to reconcile the attitude of the Chicago Company in making no charge for its services in effecting and carrying on these stock sales and in not seeking reimbursement for any expenses in connection therewith, with its use at the same time of every possible excuse to support, as an operating charge, a payment to the American Company for making available the proceeds of such stock sales to the Chicago Company.

(2) Employees' Stock Plan.

58% of the employees of the Chicago Company, and 57% of all employees of six months' or more service, were subscribers at the end of 1923 to the stock of the American Company (R. VI, 2318) under the Employees' Stock Plan established by the American Company in 1914 and already described (*supra,* 67; R. VII, 2653 (26), 2513 (17)).

These subscriptions at the end of 1923 aggregated 38,037 shares (R. VI, 2318). In addition, 15,687 shares of stock of the American Company were paid for in full by the employees in 1923, and 26,971 shares in the two preceding years (R. VI, 2318). In the years 1924 and 1925, the subscribing employees increased to over 59% of all employees, the amount of stock subscribed increased to 56,294 shares at the end of 1925, and the amount of stock paid for in full during those years aggregated 14,299 shares (R. VI, 2318). This stock was purchased upon an installment basis of a small monthly payment which was deducted from the subscriber's salary and remitted to New York by the Chicago Company. Such remittances for the year 1923 aggregated $1,500,000 and for the period of 1921-1925 aggregated $7,000,000 (R. VI, 2032). In view of the loss of allegiance of its employees through such stock sales (*supra,* 67), it can hardly be said that the Chicago Company received any benefits therefrom. On the other hand, the American Company received not only the benefit of the continued allegiance of these employees, but a ready and steady market for its own securities.

(c) *Profit to American Company Through Filing Consolidated Federal Income Tax Returns and Charging the Subsidiaries on the Basis of Separate Returns.*

Consolidated federal income tax returns have been filed which include the American Company, the Chicago Company, and the other members of the Bell System, totaling 240 companies, since the Government required or permitted consolidated returns beginning with 1917 (R. V. 1832; R. VII, 2585 (28).* But each of the subsidiary companies including the Chicago Company was charged by the American Company on the basis of the separate returns of each (R. V. 1832). Some of the subsidiaries showed net losses from operations (R. V. 1832). These losses, therefore, served to reduce the taxable net income of the profitable subsidiaries, including the Chicago Company, under each of the Revenue Acts to 1925, inclusive** (Article 637, Regulations 62).

In the absence of an agreement among the consolidated companies as to a different method of apportionment of the consolidated tax among the respective companies, the consolidated tax is apportioned among and assessed upon the respective companies on the basis of the respective net incomes properly assignable to each (Section 240, Revenue Acts of 1918 and 1921). Under this provision, in the absence of a special agreement, the portion ascribable to the Chicago Company would, under the facts just stated, be less

*Consolidated returns by affiliated corporations were first required under the Revenue Act of 1917 (Articles 77 and 78 of Regulations 41 and Treasury Decision 2662, March 6, 1918, and Section 1331, Revenue Act of 1921). Consolidated returns have been required or permitted continuously since that time (Section 240 in each of the Revenue Acts of 1918, 1921 and 1924).

**In addition to the straight income taxes as such, there were the graduated excess and/or war profits taxes for the years 1917 to 1921, both inclusive. In the determination of such taxes the invested capital of the non-profitable subsidiaries served to reduce further the resultant tax on the income from the profitable subsidiaries (Revenue Acts of 1917, Title II; Revenue Act of 1918, Title III; Revenue Act of 1921, Title III).

than the tax computed upon a separate return of its own income and invested capital. By charging the Chicago Company on the basis of a separate return, the American Company received from it as a charge for Federal income taxes, substantially more than the tax actually assessable against it under the foregoing provision. Such excess must, therefore, be regarded as additional income yield to the American Company out of the operations of the Chicago Company.*

The exact amount of special profit to the American Company as a result of its method of apportioning the taxes to the Chicago Company as part of the Consolidated System cannot be determined without knowledge of the actual figures of the American Company and of the included subsidiaries. No evidence has been offered of the amount nor has the Chicago Company been given any credit therefor. But that such special profit in fact did exist, is certain.

(d) *Profit to American Company Through Its Method of Financing Licensee Companies.*

The Chicago Company suffered losses because of the difference between the manner in which the American Company financed the Chicago Company (by investing therein only in stocks yielding 8%) and that in which it financed the other Bell licensee companies (by investing therein partly in stock yielding 8% and partly in credit obligations yielding 5.88%).

During the period from 1918 to 1925, inclusive, the Chicago Company paid 8% dividends on 97.9% and 5.88%

*If the American Company itself had relatively little taxable income (the dividends from subsidiaries are not taxable income) (Section 234-a-6, Revenue Act, 1921), the charging of the tax item to the subsidiaries on the basis of separate returns would result in an aggregate payment to the American Company by the subsidiaries of more than the actual consolidated tax payable, and such excess payment if made pursuant to contract, would be profit to the American Company *but free from tax* because eliminated under consolidated returns as inter-company transactions.

dividends on 2.1% on the money investment in it of the American Company (R. V, 1860; R. VI, 1982; Appendix, 78). During the same period, the other licensee companies of the Bell System paid 8% on 73.7% and 5.88% on 26.3% of the money investment in them of the American Company (Appendix, 78; R. V. 1813). The difference of at least 2.13% payment on 24.2% of the average money investment of the American Company during this period, represents a loss to the Chicago Company of $215,000 and a corresponding profit to the American Company from the difference between its method of financing the Chicago Company and that of financing the average licensee of the Bell System.*

C.

The service of making available inventions and improvements embodied in manufactured apparatus in 1923 was and since 1908 has been covered by the price paid to the Western Electric for such apparatus.

To avoid confusion, it is necessary to divide these services into two classes:

1. The service of determining and recommending the purchase of improved manufactured articles, whether manufactured by the Western Electric or by others; and

2. The service of developing and making available improvements and inventions embodied in manufactured articles of the Western Electric.

The first class of service is part of the normal service of management and will be considered in connection therewith (*infra*, 239). The second class will now be considered.

*Under the financing plan of the Bell System as a unit, wherein the Chicago Company is considered a *department*, this discrimination against the Chicago Company is removed (*infra*, 374).

Illusory Basis of Calculating Benefit.

The Chicago Company used as a basis of calculating the benefit derived by it from the services of the American Company resulting in improved patented and non-patented apparatus, the annual financial savings derived from the use of such apparatus (R. III, 1044). To measure the amount of benefit from a particular improvement, it did not compute the annual financial savings of the latest development over the last previous development or over the state of development existing when the 1919 Memorandum became effective; instead it computed the savings in annual charges resulting from all the developments in the telephone art since the first Bell patent (1877) to the development embodied in the particular apparatus under investigation (R. III, 1039; Pl. Ex. 60 opposite R. IV, 1550).

This basis of calculation is fatally defective in that it fails to take into account three essential facts:

(1) The fact that since 1908 the inventions embodied in patented and non-patentable articles manufactured by the Western Electric have become available to independent telephone companies through their purchase without the making of any additional payment to the American Company;

(2) The fact that non-patented articles manufactured by the Western Electric are made available to the Chicago Company and to independent telephone companies by other manufacturers through their purchase without the making of any additional payment to the American Company;

(3) The state of the art already available to the Chicago Company and to independent telephone companies on February 1, 1919, the effective date of the 1919 Memorandum, on which date was established for the first time the obligation of the Chicago Company to include, as part of the services for which the 4½% payment was made, the services

of developing and making available improvements embodied in manufactured articles.

Since 1920 the Chicago Company has been entitled to purchase both patented* and non-patented apparatus manufactured by the Western Electric on the basis of its being a "most favored customer" (R. VI, 2338). To establish compliance by the Western Electric with this provision, the Chicago Company compared the prices of both classes of apparatus charged to it with those charged to non-licensee telephone companies (*infra*, 290). It did not make comparison of Western Electric prices on the basis of comparison between the single payment by the independents and its own payment to the Western Electric for the apparatus plus the additional compensation or royalty included in the 4½% payment to the American Company. Nor did it make the comparison of Western Electric prices on the basis of comparing with its single payment to independent manufacturers for non-patentable apparatus, its payment to the Western Electric for the same apparatus plus the additional compensation allocable thereto included in the 4½% payment to the American Company. The comparisons clearly show that there is no differential in favor of the prices charged to the Chicago Company by the Western Electric to properly permit any additional payment by the former to the American Company; in fact, the comparisons do not show that on a comparable basis the Western Electric prices to the Chicago Company are fair without taking into account any payment to the American Company are unfair (*infra*, 294).

The fallacy of going back beyond February 1, 1919, to figure the benefit to the Chicago Company from improved apparatus is fatal. The inclusion of the benefits of

*In 1923, 74% of all patents held or controlled by the American Company came from or were owned by the Western Electric; 11% were created by the General Staff; 15% came from employees of the Associated Companies and others outside the Bell System (R. III, 1010).

improvements made prior thereto as part of the benefits of the services made available thereafter is necessarily predicated on the proposition that no such prior improvements were available to the Chicago Company. But both the Chicago Company and the independent companies since 1908 have had available all improvements in patented apparatus manufactured by the Western Electric by the purchase thereof and have had available all improved non-patentable apparatus manufactured by the Western Electric and by any other manufacturer producing the same class of apparatus.

Distorted Picture of Benefit of Services.
Fine Wire Cable.

As illustrative of the distorted picture presented by the Chicago Company to support the 4½% payment, we cite its computations of benefit derived from the use of fine wire cable.

The Chicago Company estimated an annual saving to it through the use of fine wire cable of $1,230,000 in 1923 (R. III, 1040). The basis of comparison was between annual charges on 909 pair No. 22 and No. 24 Gauge Cable on the one hand and 100 pair No. 19 Gauge Cable in use in 1892 on the other hand (disregarding all intermediate improvements in cable) (R. III, 1040). As the annual charge merely represents fixed percentages of original cost, it is obvious that the use of the wrong original cost basis of comparison will destroy the value of the entire calculuation. The following showing of comparative original costs is illuminating:

Between 1892 and 1923 there were several improvements in No. 19 and No. 22 Gauge Cable, each of which reduced the original cost. The cost of 909 pair No. 22 Gauge Cable and the No. 24 Gauge Cable in use in 1923 was 78% and 80%, respectively, than the 100 pair No. 19 Gauge Cable in

less

use in 1892, but only 11% and 22% less, respectively, than the 455 pair No. 19 Gauge Cable in use in 1911 (Pl. Ex. 60, opposite R. IV, 1550).

The measure of benefit used by the Chicago Company, calculated on a basis which gives effect to the difference in the original costs of the latest and of the first model cable without making allowance for the intermediate improvements in models resulting in the reduced original cost, is clearly worthless.

No. 22 and No. 24 Gauge Cable were sold by independent manufacturers (R. IV, 1560). The maximum difference in favor of Western Electric prices of cable purchased by the Chicago Company from the price charged for the same cable by independent manufacturers in 1921 was 25.09% (R. IV, 1560). A saving of $1,230,000 through the use of such cable in any one year would require a purchase by the Chicago Company of at least $6,000,000 cable from the Western Electric. The ratio of total purchases from the Western Electric of all classes of cable in 1921 was less than 6% of the total purchases of apparatus plus cable from that manufacturer (R. IV, 1560). Applying the same ratio to the year 1923, the purchase of $6,000,000 cable would require total purchases of apparatus plus cable of over $96,000,000. Yet the total purchases of all classes of apparatus plus cable in 1923 for all divisions of the Chicago Company were less than $10,500,000 (R. VI, 2062).*

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*The calculation made in the text does not give the Chicago Company, in the comparison of prices, the benefit of the many factors of saving to the Western Electric by virtue of its relationship to the Chicago Company which are not enjoyed by independent manufacturers, which savings must first be deducted from the Western Electric prices to the Chicago Company to reduce them to a comparable basis to those charged by such independent manufacturers (*infra*, 286). If such adjustments are first made, no difference in price between the same cable purchased from the Western Electric and from the independent manufacturer could possibly bring about $1,230,000 savings in one year as a result of purchase from the Western Electric.

The basis of calculating tangible benefit from the use of fine wire cable was applied to all other items as well (R. III, 1040-43). For the reasons stated above, the calculations should be rejected.

Such portion of the 4½% payment as is allocable to the services embodied in improved patented and non-patented apparatus is an improper charge to operating expense.

D.

The service of business management in 1923 was more than compensated by the excess charge of $120,000 included in the amount charged for rental of telephone instruments, by eight special financial services rendered by the Chicago Company to the American Company in 1923, and by the special benefit to the Western Electric resulting from the action of the American Company in the course of its service of business management.

1. *Erroneous Method of Calculating Benefit Used by Chicago Company.*

We have already noted that no measurable standard was prescribed by the 1919 Memorandum by which the fairness of the charge for the service of business management might be established and that the charge upon the basis of a percentage of gross revenue bore no relation to the cost of the service rendered or the benefit therefrom to the Chicago Company.

The Chicago Company did not test the fairness of the charge upon its relation to the cost of service rendered but only on the basis of benefit of the service to the Chicago Company.

The showing is wholly inadequate to support the charge of $1,015,243 or any substantial portion thereof.

As typical of the evidence of benefit offered, we cite the following.

(a) *Operating Methods*:

The American Company has furnished books relating to the operating methods to be employed in the telephone service in Chicago. But the operating methods used in 1923 represent an evolution. The American Company acknowledged as early as 1896 that it was receiving the benefit of the developments in operating methods brought about by the operating personnel of the various licensee companies (R. VII, 2385) (11-12)). From 1896 to 1908 we find repeated admissions by the American Company that the development of the operating methods was by the management of the licensee companies, including the Chicago Company (R. VII, 2385 [11-12], 2411-12 [8-9], 2415 [19], 2421 [13-14]). It is certainly an extravagant claim for the American Company to charge in 1923 for giving to the Chicago Company the use of the operating methods which had been developed by the Chicago Company and the other licensees prior thereto and the benefit of which had been given to the American Company. Particularly is it extravagant where the operating methods were in existence in 1919, the effective date of the 1919 Memorandum.

There is no evidence in the record to show the development in the operating methods resulting in tangible benefits beginning with 1919 over and above those already existing on that date.

(b) *Guaranty Under Employees' Benefit Plan.*

The guaranty under the Employees' Benefit Plan is illusory and has never been exercised. At most it would give the Chicago Company a part of the $2,000,000 guaranty fund in proportion to the number of licensees plus the American Company and Western Electric, all of which could par-

ticipate therein. Furthermore, the conditions of participation depend on the judgment of the American Company (*supra*, 204).

(c) *Personnel Services.*

The personnel services given to the Chicago Company involve mostly the sending of literature which is especially written for the Bell System and which either helps to sell the stock of the American Company (R. VI, 2263) or helps to transfer the allegiance of the employees from the Chicago Company to the American Company.

The Chicago Company advertises the stock of the American Company in its directory to its 600,000 subscribers without charge (R. VI, 2325), and uses part of its yearly advertising expense of $100,000 in advertising the American Company, without cost to the latter (R. I, 251). Such expenditures probably more than offset the expense of distributing the literature to the employees of the Chicago Company.

(d) *Recommendations to Purchase Apparatus.*

The American Company acts as purchasing agent for the Chicago Company and as selling agent of the Western Electric for all merchandise manufactured by or through the Western Electric or purchased through the Western Electric. As purchasing agent the American Company defines the type of article to be purchased and specifies the manufacturer from whom it shall be purchased, to-wit: the Western Electric Company; it gives the final directions to the Western Electric as to the filling of the order when any question arises either as to the ability of the Western Electric to fill the same as specified, or when substitutions of equipment are deemed necessary by the American Company to replace the item ordered for the Chicago Company (R. V, 1589-92).

As selling agent, the American Company makes available to the Chicago Company improvements in apparatus through the pamphlets issued by the Western Electric; its recommendations to the Chicago Company for new or improved equipment are made with reference to equipment manufactured by or under the control of the Western Electric; it advises the Associated Companies of all special quantities of equipment on hand by the Western Electric for sale; it designates the code number, article number, and method of order from the Western Electric; it makes up and furnishes to the Chicago Company specifications for equipment manufactured by the Western Electric; it describes to the Chicago Company the different types of equipment and improvements thereon as manufactured and made by the Western Electric (R. V, 1592; R. VI, 2196-2223).

It is obvious that the service of selecting and recommending apparatus is confined to the selection and recommendation of the articles manufactured by the Western Electric. The American Company in rendering the services of selecting and recommending apparatus to the Chicago Company is in reality rendering the service of acting as the selling agent for the Western Electric. The record does not show that the saving to the Western Electric from the transfer of the expense of its sales department to the American Company and, through the 4½% arrangement, to the Chicago Company has reflected itself in the margin in favor of prices charged by the Western Electric to the Chicago Company as against those charged to non-licensees. The benefit to the Western Electric and through it to the American Company of confining the purchases to the Western Electric more than offsets the costs of sending the literature or of rendering the service.

2. *Compensation for Services Stated.*

Whatever may be the cost to the American Company or the benefit to the Chicago Company from such management service, the former has been more than compensated therefor by the excessive amount of $120,000 included in the charge for rental of instruments (*supra*, 218), the financial services rendered by the Chicago Company free of charge (*supra*, 147) and by the profit to the Western Electric (and through it to the American Company, as the owner of 99% of its stock) derived from the sale to the Chicago Company of apparatus recommended by the American Company as part of its service of business management.

The charge for operating expense in 1923 of $1,724,243 to cover the payment to the American Company is excessive and should be reduced by $1,015,243.

3. *Authorities Analyzed and Classified.*

We recognize that this Court in the *Houston* case (259 U. S. 318) and in the *Missouri* case (262 U. S. 276), as well as many other Courts and Commissions, have passed on some phases of the 4½% payment made by the Bell licensees to the American Company, and that the approval of the payment as an operating charge has been the common practice.* *No case presents on its record issues based upon essential facts similar to those of the instant case.*

*In examining the authorities at this point we are, of course, confining the discussion only to those cases wherein the issue is not present of domination and control to reduce the licensee to an agency or instrumentality of the American Company. The cases containing that issue are discussed (*infra*, 271).

HOUSTON CASE DISTINGUISHED.

1. *This Court Passed Only on the Issue of the Fairness of the Charge for Rental of Instruments.*

The *Houston* case involved cross appeals in a suit to restrain the enforcement of an ordinance enacted by the City of Houston, Texas, prescribing rates for telephone service. This Court affirmed the order of the District Court which had issued and enjoined the enforcement of the ordinance. The District Court upheld the 4½% charge and this ruling this Court sustained, holding:

> "Second and Third: The American Telephone & Telegraph Company owns substantially all of the stock of the Company and a large majority of the stock of the Western Electric Company. From the American Telephone & Telegraph Company the *Company leases its instruments and secures their maintenance and renewal,* * * * It is contended by the City that no fair disclosure was made of the profits made by the furnishing companies on the instruments and on the material and supplies so furnished, and that, for this unique reason, the Company should not be heard in a court of equity and the case should be dismissed. It is true that the Company did not introduce proof to show what the profits of the two companies were, either upon the business done with it or on their entire business; but it did introduce much evidence tending to show that the charge made and allowed for the services rendered and supplies furnished by them was reasonable and less than the same could be obtained for from other sources." (259 U. S. 318, at 323.) (Italics ours.)

It is clear that this Court was concerned solely with that part of the 4½% payment which the Southwestern Bell allocated as payment for rental of the telephone instruments.

2. *The Issue in the Houston Case of the Fairness of the Charge for Rental of Instruments was Based Upon Considerations Entirely Different from Those Existing in the Instant Case.*

The issue in the instant case is the fairness of the payment for rental of instruments considered on the basis of facts appearing in the record; in the *Houston* case the issue was whether, because of the existence in the record of the fact of a majority of stock ownership by the American Company in the Southwestern Bell, the fairness of payment for rental (found fair on the facts in the record) should be tested upon the basis of facts not appearing in the record, required to show the cost of the service to the American Company.* In the *Houston* case this Court found that the fairness of the rental was established by the facts appearing in the record; in the instant case the issue of fairness of rental is in issue in view of the facts in the record involving the excessive yield to the American Company on its investment in instruments compared to the yield to the Chicago Company on its investment in property rented by it to the American Company in 1923.

3. *There was no Issue in the Houston Case of the Fairness of the Charge for Services of Business Management or of Making available Inventions and Improvements in Manufactured Apparatus.*

The record in the *Houston* case discloses the following facts: The total payment by the Houston Exchange for rental of instruments plus services was $42,792, allocated into $28,541 for rental and $14,251 for other services (Rec. Houston case, Vol. II, 940; Vol. 1, 334, 339, 340). The Houston Exchange required $500,000 for the extension of

*In the instant case, the evidence of cost to the American Company is in the record (R. III, 1126).

its business in the year 1920 (Rec., Houston case, Vol. I, 442). The stock of the Southwestern Bell was paying to the American Company 5% dividends (Appendix, 1). The credit obligations of the Southwestern Bell to the American Company were bearing interest at the rate of 5.88% (Rec., Houston case, Vol. II, 958, 960). The Houston Exchange had not earned its operating charges for two years prior to 1920 (*Houston case*, 259 U. S. 318, 320). The uncontradicted evidence in the case was that in 1918-1919 money could not be had in Houston at less than 8% interest and commissions in excess of 10% on credit obligations and even larger discounts on stock sales.* (Rec., Houston case, Vol. I, 184-6.) The difference between the charge to the Southwestern Bell of 5% on capital obligations or 5.88% on credit obligations, and the cost to the Southwestern Bell of providing $500,000 through independent sources, more than absorbed the $14,251 allocated as payment for all services other than the rental of instruments. The payment of that amount was clearly justified.

The issue of the fairness of any charge for the services of making available inventions and improvements in manufactured apparatus and of business management was moot.

Even if an issue is considered to have been raised in the *Houston case* as to the fairness of the charge for these services because of the existence in the record of the fact of majority stock ownership by the American Company, the issue in the two cases is based upon entirely different considerations.

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*The cost to the American Company of procuring the funds with which to finance the Houston Exchange in 1918 was 8.33%; in 1919, 7.17%; and in 1920, 8% (R. VI, 2296).

In the *Houston case*, the effective date of the contract creating the right in the Southwestern Bell to demand and the obligation of the American Company to supply all services, including the rental of instruments, in consideration of the payment by the former of 4½% of its gross operating earnings was 1907 (*supra*, 175). The Company could properly show performance by the American Company since that date in support of the contract. In the instant case, the effective date of the contract creating the same rights and obligations was February 1, 1919. The Chicago Company sought to support the contract by showing benefits to it after that date from the developments made by the American Company for 40 years prior thereto, using as the measure of such benefits the cumulative result of such development from the earliest period and not from the effective date of its contract. In the *Houston case* the issue would be whether the fairness of the payment for all services should be tested upon facts not appearing in the record, showing the cost to the American Company of the various services rendered. In the instant case the fairness of the charge is in issue in view of the facts appearing in the record involving (a) the fact that the financial service was neither required by nor given to the Chicago Company—a fact not appearing in the *Houston case*; (b) the fact that the provisions covering inventions and improvements embodied in manufactured apparatus contained in certain contracts between the American Company and Western Electric, between the Chicago Company and the American Company, and between the Chicago Company and the Western Electric, limit the maximum compensation for the service of making available such inventions and improvements; and also the fact that the compensation for such service was already covered by the purchase price paid to the Western Electric for such patented and improved apparatus—facts not appearing in the *Houston*

case; (c) the fact that no probative evidence of cost of or benefit from the service of business management is contained in the record in the instant case to warrant any charge therefor, over and above the payments made to and benefits received by the American Company included in the excessive charge for rental of instruments, in eight special financial services performed by the Chicago Company without charge, to the American Company, and in the profit to the Western Electric from the activities of the American Company in the course of its performance of the service of business management—facts not appearing in the record in the *Houston case.* It is therefore clear that the issue in the two cases of the fairness of the charge for all services other than the rental of instruments is based upon entirely different considerations.

4. *The Decision in the Houston Case Is Authority Against the Sanction in the Instant Case of the Charge Made for the Services of Business Management.*

Since 1907 the Southwestern Bell has had a contract with the American Company to pay to it 4½% of its gross operating revenues for the rendering of all services—rental of instruments and royalty for use of patented apparatus and all other services (Appendix, 39). Inasmuch as the $14,251 payment for all of the services other than the rental of the instruments is absorbed in the rebate in interest through the financial service alone, the Houston Exchange received the benefit of all other services than the rental of the instruments and financial assistance without making any payment whatsoever therefor. In the instant case the City of Chicago has made an issue of that part of the 4½% charge made in 1923 against the Chicago Exchange for all services other than the rental of the instruments—in particular the charge of $1,015,243. As the Chicago Company neither received nor required financing

assistance and the purchase price of improved apparatus compensated for the service of making available such apparatus, we have, in the instant case, an issue of the fairness of a payment of $1,015,243 for the right to receive the service of business management which the Houston Exchange also received but for which it paid absolutely nothing. Either the business management service is negligible or the Chicago Company is being discriminated against.

Financial Support of Southwestern Bell by American Company.

There is a striking difference between the situation of the Southwestern Bell in its entire operations, including the Houston Exchange, during the years under investigation in the *Houston case*, and the situation of the Chicago Company during the period under investigation in the instant case.

As already noted (*supra*, 192), the Southwestern Bell paid, in the year 1918, $1,092,363, of which $334,006 was payment for all services other than for the rental of the instruments. In the year 1918 the Southwestern Bell owed the American Company $10,505,221, on which it paid 5.88% interest. Assuming that the Southwestern Bell paid no commission for procuring this large loan, and assuming that it could have borrowed from other sources at the same cost which the American Company paid to procure capital in 1918, the difference between such cost of 8.23% and the actual charge of 5.88% represented a rebate of $257,378. Of the total payment under the 4½% contract with the Southwestern Bell for all services other than for the rental of instruments, there remained only $76,628, or 7%,* to

*Taking the three years with which this Court was dealing in the *Houston case*, we find as above noted (*supra*, 192) that the Chicago Company paid in 1918, 27%; in 1919, 34%, and in 1920, 41% of its total 4½% payments for such years, against 7%, 16% and 4% of the total payments made in the same years by the Southwestern Bell for the right to receive the same services from the American Company.

compensate the American Company for services rendered in 1918 other than the rental of the instruments and financial services: *i. e.*, the services of making available improved apparatus and of business management.

For the year 1923, however, the Chicago Exchange, which has in service almost the same number of stations as did the Southwestern Bell, was charged $1,015,243 for the right to receive the services of business management alone.** If the decision in the *Houston case* is used to sustain a payment of $76,628 for the right to receive the services of making available improved apparatus and of business management, the same decision should be used to condemn a payment by the Chicago Company of $1,015,243 for the service of business management alone.

Dividends on Capital Paid by the Southwestern Bell Contrasted with Record of Chicago Company.

The above gross unfairness to the Chicago Company does not take into account the great discrepancy in the charge to each of these companies for the funds represented by the American Company's stock holdings in the respective Companies. The average yearly dividend paid on the stock of the Southwestern Bell during the period of 1883 to 1919, inclusive, was 5.36% (Appendix, 1); the average yearly dividend paid on the stock of the Chicago Company for the period 1882 to 1919 was 17.72% (Appendix, 78). No euphonious pretense of benefit of an intangible nature alleged to have been derived from the relationship can offset the cold scrutiny of this comparison.

Of course, the payment by the Chicago Company could be justified if specific evidence be offered to show that the Chicago Company was receiving a benefit from the service

**The financing service was not required or given; the service of making available improved apparatus was compensated through the purchase thereof from the Western Electric (*supra*, 219, 232).

of business management in an amount over and above the benefit from the same service and from the service of making available improved apparatus, rendered to the Southwestern Bell, to offset the increase in the charge made to the Chicago Company for the right to receive the one service only. But no such evidence has been offered in this case.

The decision in the *Houston case* has no bearing on the issue of the fairness of the 4½% charge in the instant case. If it be deemed to have any bearing, it is persuasive authority against the sanction of all of the charge as an operating expense, excepting only the fair annual charge for rental of telephone instruments.

MISSOURI CASE DISTINGUISHED.

The Rebate in Interest to the Missouri Company Absorbed the Entire 4½% Payment.

This Court reversed the decision of the Missouri Supreme Court, which had sustained the Order of the Missouri Public Service Commission, the latter Order having disallowed a portion of the 4½% payments.

This Court held:

> "The important item of expense disallowed by the Commission—$175,048.60—is 55% of the 4½% of gross revenues paid by Plaintiff in Error to the American Telephone & Telegraph Company as rents for receivers, transmitters, induction coils, etc., and for licenses and services under the customary form of contract between the latter company and its subsidiaries. 4½% is the ordinary charge paid voluntarily by local companies of the general System." (*Missouri Case*, 262 U. S. 276, 288).

The case is distinguishable on the facts. The uncontradicted testimony of the General Manager (Rec. Missouri Case 349) and Treasurer (*Idem* 351-2) of the Missouri Com-

pany was that substantial discounts from par would have been required to procure the financing of the $25,614,068 owing in 1919 to the American Company (*Idem* 161, 349, 352); the Treasurer testified that the savings in one financial transaction alone would more than absorb the entire payment made (*Idem.*, 352-3). It was admitted that the financing of such a large amount on any basis would have been impossible without the assistance of the American Company in view of the financial history of the Missouri Company (*Idem.*, 352).*

The charge for the services of financing, of making available improved apparatus and telephone instruments, and of business management, was fair upon the basis of the benefits from financing service alone.** The issue of the fairness of the charge for the other two services was moot. The decision is no authority on the issue in the instant case of the fairness of the same charge for the management service alone.

In the *Missouri case*, as in the *Houston case*, there was the same issue of testing the fairness of the charge (otherwise fair on the facts appearing in the record) upon facts not in the record, because of the existence in the record of the fact of a majority stock ownership by the American

*In 1917-18 the Missouri Company paid 5% cash dividend on $30,500,000 stock, of which the American Company owned 99% (Rec., Missouri case, 159). From 1907 to 1916 it neither paid nor earned any dividends; the average annual dividend paid from the date of its organization in 1882 to 1916 was 1.43% (Rec., Missouri case, 156). In 1910 the American Company exchanged $10,000,000 demand notes bearing 6% interest for an equal par amount of stock on which, as already noted, it received no dividends to 1917 (Rec., Missouri Case, 174). The additional properties acquired by the Missouri Company in 1917 had only earned and paid dividends of 4%, or less, from 1911 to 1916, and only 5.9% average yearly dividends from 1880 to 1916 (Rec., Missouri Case, 163).

**From the facts appearing in the record in the instant case, the cost to the American Company of procuring capital in 1918 was 8.33% and in 1919, 7.17% (R. VI, 2296). On the basis of either cost the rebate in interest to the company through the charge to it of 5.88% interest on advances aggregating $25,614,068 more than absorbed the entire payment by the company (*supra*, 192).

Company. For the reasons already stated such issue does not exist in the instant case (*supra*, 218).

The record in the *Missouri case*, as in the *Houston case*, did not contain the special facts appearing in the record in the instant case, which, as pointed out in connection with the decision of the *Houston Case*, raise a special issue of unfairness in the instant case.

DOMINATION AND CONTROL OF THE BELL SYSTEM BY THE AMERICAN COMPANY.

The American Company has reduced the Chicago Company to a mere agency and instrumentality of its own business.

The Order of August 16, 1923, disregarding the 1919 Memorandum as a bilateral contract, held:

> "Because of the overwhelming stock ownership by the American Telephone & Telegraph Co. in the Illinois Bell Telephone Company and the consequent domination of the Board of Directors of the Illinois Bell Telephone Company, it can hardly be said that the so-called contract was made between separate parties" (R. I, 39).

The Statutory Court disposed of the same issue as follows:

(1) The Bell System was and now is being operated with the avowed purpose of rendering a nationwide and unified telephone service (R. I, 180); (2) the evidence shows a coordination of activities with a view to producing an efficient unified service (R. I, 182); (3) the American Company in this coordinate effort undertakes the solution of the problems that are common to the Bell System as a whole, "leaving to the local companies responsibility for local affairs" (R. I, 180); (4) "the plan of organization, the ownership of property and the method of operation show

that the American and Illinois Companies functioned in distinct fields of activity" (R. I, 182); (5) stock ownership by the American Company gave to it the power to control the Chicago Company through the election of directors (R. I, 180); (6) the record does not show that the contracts between the two companies "were made in bad faith and as a device for unduly enhancing the earnings of the American Company at the expense of the Illinois Company" (R. I, 183); and (7) the evidence in the record is not sufficient to warrant the legal conclusion that there was such an exercise by the American Company of its power to control as to make the two companies practically one with the legal consequences attached thereto as laid down by this Court in *United States* v. *Delaware & Hudson Co.*, 213 U. S. 366; and *C. M. & St. P. Ry. Co.* v. *Minneapolis Civic & Commerce Assn.*, 247 U. S. 490 (R. I, 180).

Legal Principles Stated.

Whether stock ownership has been used for the purpose of participating in the affairs of the subsidiary corporation in the normal and usual manner, or for the purpose of controlling the corporation so that it may be used as a mere agency or instrumentality of the owning company, is a mixed question of fact and law (*C. M. & St. P. Ry. Co.* v. *Minneapolis Civ. & Com. Assn.*, 247 U. S. 490). The decision in each case depends, therefore, upon its own facts. To prove the domination and control to which the law attaches special legal consequences, neither is the fact of stock ownership alone sufficient, on the one hand (*Houston case*, 259 U. S. 318), nor, on the other hand, is it necessary that the additional facts show bad faith or fraud (*United Fuel Gas Co.* v. *Railroad Commission of Kentucky*, 278 U. S. 300). It is sufficient that such additional facts show merely the existence of control by the owning company over the subsidiary company and over its services or products—control

which was rendered possible by stock ownership, but which was not the necessary result of a bona fide exercise of such ownership, and which could only have arisen through the use by the owning company of its stock ownership, for the purpose of giving it, the owning company, as a corporation, for its own purposes, complete power over the affairs of the subsidiary company, just as if the latter company were a mere department of the owning company—a situation such as could not have existed had the fact that the two corporations were separate and distinct legal entities been regarded in the administration of the affairs of the subsidiary company (*United States* v. *Lehigh Valley R. R. Co.*, 220 U. S. 257, 272-3).

ERROR OF STATUTORY COURT.

The error of the Statutory Court lies in this: Having found that the Bell System was operated to render a unified nationwide telephone service, the Statutory Court failed to take into account and to give effect to those facts in the record which show that the necessary fundamental and functional characteristics of such a service require that the American Company so control, and that it in fact did so control, the property and services of the Chicago Company without limitation of its property ownership and without limitation in the administration of its affairs arising from legal restraints incident to the separate and distinct corporate existence of the Chicago Company.

SUMMARY STATEMENT OF CITY'S CONTENTION.

The domination and control by the American Company, which we shall show exists in law, as a result of its policy of unified operation which the Statutory Court found to exist in fact, arises from the economic and physical necessities of such operation. The extent of its progress in ren-

dering such unified nationwide service is in direct proportion to the extent to which its stock ownership in the several subsidiary companies can be used by the American Company to operate their property and personnel without limitation of their property ownership, and without limitation in the administration of their affairs arising from legal restraints incident to the separate and distinct corporate existence of each such subsidiary company. The Statutory Court gave recognition to the accomplishment of this progress but failed to attach to it the legal consequences naturally and necessarily flowing therefrom so that the public served in Chicago may not lose thereby through discrimination and excessive cost any possible gain in service rendered by virtue thereof. To attach these legal consequences will in nowise disrupt or destroy the Bell System or its plan of operation, as it only involves the application of the machinery provided by the American Company itself to permit an equitable adjustment in lieu of a strict accounting of its operations as between the separate parts of the Bell System and for the protection of the public in the various communities served by it. The machinery itself and the necessary data for the application thereof are in the record (*infra*, 357); the result of its application shows conclusively that the full net amount available for return from the operations of the Chicago Exchange is more than the minimum to which it is constitutionally entitled.

DISCUSSION.

I.

THE AMERICAN COMPANY HAS REDUCED THE CHICAGO COMPANY TO A MERE DEPARTMENT OF ITS OWN BUSINESS.

The simple way of coming at once to the heart of the error of the Statutory Court and clearing it of all confusion is to determine the fundamental and functional characteristics of a nationwide unified telephone service. If we are able to identify them, we can readily identify the necessary consequences thereof to each of the companies, including the Chicago Company, participating therein.

Beginning with 1908, the American Company adopted the policy of offering to the public an efficient nationwide long distance service from every exchange station to every other exchange station in the Bell System, without limitation of distance or of property ownership. By 1923, the policy was an accomplished fact (R. VII, 2644 [7]).

From a consideration of the fundamental facts of telephone operation involved in the rendering of long distance service over the wires of separated companies, already described (*supra*, 37), it is clear that this policy of the American Company necessarily requires that every word or act of every individual, instrument, current or device concerned in making up and in maintaining the circuits, must be regulated or controlled. Employees and apparatus must act automatically and instinctively, and must be free from other obligations or duties. They must be subjected to strict observation of rules and regulations imposed by the operator of the long distance service, who alone must have control over them at all times to make them available for and of use in performing their particular functions in the long distance service (R. VII, 2566 [42]; R. VII, 2670 [7]).

A.

Weakness of multiplicity of ownership and of management in rendering a unified nationwide telephone service.

It is, of course, obvious that to render such service more is necessary than mere agreements to piece together the wires and equipment of the local companies where such properties are owned by separate and distinct corporate entities and are operated by independent managements. Physical connection, without single ownership and single management, is imperfect in that (1) the highway of communication may be made up of heterogeneous units of exchanges and lines which may not fit into the other parts wherever they may be located throughout the Bell System (R. VII, 2468 [46]; (2) long distance service may be at the mercy of the employees of each separate company who, owing allegiance only to their own subscribers and to their own employers, will be fighting for precedence and for circuits for their own services (R. VII, 2566 [42]); (3) the entire long distance service will be in constant danger of disruption through the failure of any one or more of the separate companies to maintain their plants and service at the required standard for long distance service for any one or more of six reasons, to-wit: (a) its or their inability to finance as an independent enterprise; (b) the maintenance and operation, on a standard adequate for local service in a particular community but not adequate for the long distance service as developed in other parts of the Bell System, of the exchange plant and operating personnel in connection therewith which is necessary in the long distance service but which is used also in the exchange service; (c) the variation in, and lack of coordination of, the operating methods of the exchange operators and personnel of the separate companies in connecting,

disconnecting and maintaining the property in their territory forming a necessary link in the through highway of communication (R. VII, 2475-6 [26]); (d) the failure or refusal of the separate companies to adopt uniformly the same changes in apparatus and operating methods that are deemed necessary or used in other parts of the Bell System and that form essential parts of the highway of communication or of the operations of the long distance service; (e) the failure or refusal of any one manufacturer to supply, in a coordinated manner, the requirements of each and every separate company; and (f) the unequal distribution of the necessary skilled personnel among the separate companies.

B.

Eleven Steps Taken to Overcome Weakness of Multiplicity of Ownership and of Management.

Beginning with 1908, the American Company undertook to overcome the difficulties incident to the multiplicity of ownership of property and of management thereof in the Bell System in the following manner:

1. To avoid any question of "conflicting interests," it acquired, in 1911, wherever possible, large independent minority stockholdings in the different licensee companies, including the Chicago Company, and thereafter constantly added thereto so that on June 30, 1923, it owned directly or indirectly 100% of the stock of fifteen licensee companies, 99.9% of the stock of four others; 98.5% of the stock of the Chicago Company; 89% of the stock of one other; and over 57% of the stock of two others (R. VI, 2280). These companies covered the entire territory of the Bell System operated by Bell Companies excepting Cincinnati, Ohio, and the State of Connecticut, where additional licensee companies operated of which in each case the American

Company owned more than 29% of the stock (R. VI, 2280). It also owned 100% of the stock of thirty-three companies organized in thirty-two separate states of the United States, including Illinois, which were not operating companies but which held the title to the Long Distance Plant of the American Company and which had no functions other than the exercise of the right of eminent domain for the American Company (R. VI, 2282). It also owned 100% and 70% respectively of the stock of the two Building Corporations which housed the American Company; 100% of the stock of the Bell Telephone Securities Company which distributes the securities of the Bell System; and 98.29% of the stock of the Western Electric (R. VI, 2283).

2. We have already noted how the American Company provided a uniformity and interchange of skilled operating personnel for the Bell System as a whole by the adoption under its own control of the Employees' Benefit Plan, through which any employee of any licensee company, or of the Western Electric, or of the American Company itself, could aspire to work anywhere in the Bell System, and any of these companies could obtain any man it needed without prejudice to his welfare and with uninterrupted benefits to him. The Chicago Company adopted this plan in 1912 and all of its employees were enrolled thereunder in 1923 (*supra*, 66).

3. We have already noted how the American Company in 1914 provided a plan to transfer the allegiance of the employees of each licensee company from the company itself to the Bell System as a whole by the adoption of an Employees' Stock Plan, entirely under its own control, under which each employee of the Bell System was offered under certain conditions the right to subscribe for stock of the American Company at prices designated by it and on an easy installment basis of payment deductible from his salary and collected and remitted free of charge by his em-

ployer company. The Chicago Company adopted this plan in 1914 (R. VI, 2031). Between that time and 1923, the American Company gradually eliminated the qualifying conditions of subscription and in 1923 over 80% of all employees were qualified to subscribe. Beginning with 1921 it removed all limitations of time within which such subscriptions could be made (R. VI, 2318). Some employees subscribed in each year beginning with 1915. In 1923, 45% were subscribing to over 38,000 shares; the average number of employees subscribing from the period 1921 to 1925 was more than 50% of all employees of the company, and the average stock subscribed per year exceeded 40,000 shares (R. VI, 2318). The collections by the Chicago Company and payments to the American Company from the salary of these employees during the year 1923 was $1,500,000, and for the period 1921 to 1925 was over $7,000,000 (R. VI, 2032).

The number of subscribers among employees of the Bell System in 1921 comprised 46% of all the employees of the System (R. VII, 2621 [17]). At the end of 1923, one-sixth of all the stockholders of record of the American Company were employees of the Bell System. In addition, 100,000 employees were subscribers but had not yet paid up in full and so were not stockholders of record (R. VII, 2655 [39]). By the end of 1925 the installments paid by employees on Stock Plans for stock not yet paid for in full aggregated $27,500,000 (R. VII, 2675). The American Company in 1922 said:

> "The results of the Plan evidence a sincere desire for saving and thrift among Bell System employees as well as a firm faith in the continued successful operation of the company" (R. VII, 2622 [17]).

4. We have already noted (*supra*, 154) how the American Company by 1914 had relieved each of the licensee companies, including the Chicago Company, from the obligation

of maintaining anything but an operating organization (R. III, 1074). It transferred to its own General Staff the obligation to supply and to maintain, at the expense of the licensees, all the services of the business management incident to efficient ordinary operation of their public utility functions, including the personnel to determine legal policy, to audit, to select, purchase and check the prices and quality of necessary equipment, to follow and keep ahead of the development of the art, to develop inventions and improvements in the art, to maintain a welfare department, to provide for a contented personnel, to maintain a bureau for better public relations and to represent the licensees in such relations and to settle all questions of policy or operation common to all licensee companies, or any one question arising in any one company that might affect any other company in the Bell System (R. VII, 2513 [14]). Inasmuch as from a service standpoint in rendering long distance service nothing can be done in any one company which will not affect every other company (R. VI, 2077-2078), this latter incident of the General Staff service means the settling of all questions of policy and operation of each company, only the few purely local matters which do not in any wise affect the maintenance and operation of the local exchange facilities as part of the facilities for long distance service being excepted, and then for only so long as the decisions in such matters are in complete harmony with, and in no wise disturb, the reciprocal relations of any other company of the Bell System (R. VII, 2529 [52]).

5. The American Company has set up and prescribed the standard of operation of each local operating organization, leaving nothing open for the exercise of judgment or of individual development by the operating management of the local company including the Chicago Company:

(a) It furnished to the Chicago Company, and the latter is using, the standard of efficiency for employees as estab-

lished by the American Company. This standard, and not the experience of the Chicago Company, determines the force necessary to meet the service requirements in the local exchange service in Chicago (R. VI, 2285; R. VI, 2196). The Chicago Company has based its estimate of going value upon the efficiency tables contained in the standard as established by the American Company and not upon the actual experience of the Chicago Company itself (R. VI, 2285).

(b) The Local Training Department methods of the Chicago Company are prescribed by the American Company, which latter company even retains the title to the book of instructions for operating the local service and plant of the Chicago Company (R. VI, 2248). Detailed instructions are given on how to reject an applicant, what reason to give for rejection, when to give the real reason for rejection, and when to avoid giving such reason. What to do with rejected applications, where and how they should be filed and what comments should be placed thereon, are all detailed. The management of the Training School is prescribed with the minutest detail (R. VI, 2246). The required number of the Training Staff and the duty of each member is given; the manner in which the training quarters and the operating rooms should be equipped and kept are prescribed, and each activity and movement of each and every employee is outlined, including even that of the matron. The method of conduct of employees is described, the type of directing to be used, the kind of contact to be made with customers, and the method of dealing with letters of inquiry (R. VI, 2225-2246).

(c) As purchasing agent for the Chicago Company, the American Company defines the type of article to be purchased. It specifies the manufacturer from whom it shall be purchased, to-wit: the Western Electric. Through its standardization it makes it impossible to purchase the ar-

ticles elsewhere than from the Western Electric (R. III, 1120). It follows through the filling of the order, as required by the Chicago Company, after the specification of quantity is made. It gives the final directions to the Western Electric as to the filling of the order when any question arises as to the ability of the Western Electric to fill the order as specified, or when substitutions of equipment are deemed necessary by the American Company to replace the item ordered by the Chicago Company (R. VI, 2196).

6. It has established the Western Electric as the manufacturing department of the Bell System, to which became available the entire personnel of the Bell System, as subscribers to its stock, through the Employees' Benefit Plan, the relationship of which plan to each licensee company was dependent on the licensee relationship of such company to the American Company (R. VI, 2336), and the connection of which with each such licensee was solely through the American Company (Pl. Ex. 64, opposite R. IV, 1556; R. III, 1082-3), the latter as just noted serving at the same time as the purchasing agent for each such licensee and as selling agent for the Western Electric. Moreover, it united the engineering department of the Western Electric with its own engineering department and maintained it as part of its service of common business management for the Bell System (R. VII, 2570 [20]).

7. It has enabled the separate companies of the Bell System to do service for each other and for the American Company, without any accounting between them, and even without any contract covering such operations. Thus, the entire local operating organization of the Chicago Company is made available, free of charge and without written contract, as the local selling agency for the securities offered by the Bell Telephone Securities Company, a wholly owned subsidiary of the American Company (R. VI, 2283); dial equipment in excess of $5,000,000 is built and installed by

the Western Electric without any contract covering the price or terms of charge therefor (R. VI, 2303, 2315; R. I, 387); the operating personnel of each licensee is made available to the Western Electric without compensation other than reimbursement of actual expense, for use in installation of equipment, for which service the Western Electric claims credit but which reciprocal service is not assured to each licensee company under any contract of the Western Electric with the American Company or with the other Bell licensee companies (R. III, 1099); the Chicago Company gives the free use of its local exchange plant and operating personnel in connection therewith to the American Company for the latter's use in long distance service (*supra,* 38); the Chicago Company and four other licensee companies were operated for eight years by the American Company as one operating unit, with twenty-five employees and officers, and many directors of each being the same persons (R. V, 1588; R. VI, 1989) and the distribution of common expenses being made in such a way as to be most discriminating against the Chicago Company (*supra,* 189)—all done without any contract between the companies and only upon resolutions of their respective directorates (R. VI, 1989).

8. We have already noted how the American Company combined the territory of five separate licensee companies, including the Chicago Company, into one operating unit known as the Central Group, with boundaries based upon economic considerations and without limitation of separate property ownership or of restraints incident to the existence of separate and distinct corporate entities, and upon the basis that all lines of responsibility and suggestion will go up from the local representatives to the Central Administration (of the American Company), all lines of authority down from the Central Administration to the local chief (R. VII, 2477 [28]). The basis of operation of this

Group was extended by 1918 to the entire Bell System, the operating boundaries of which were nationwide (R. VII, 2442 [8]).

9. It has protected itself and the Bell System against disintegration by making the rights of each licensee company, including the Chicago Company, to the services of the American Company, subject to forfeiture through voluntary assignment by such licensee company or by operation of law, and subject to termination by the act of the American Company in assigning its obligation to supply such services and in transferring the title to the telephone instruments used by such licensee company (R. IV, 1213). No such limitation existed in the case of the Chicago Company prior to 1919.

10. The contribution by each licensee company, including the Chicago Company, towards the maintenance and expense of the common services of business management is established upon the basis of an arbitrary percentage of its respective gross operating revenues, which percentage bears no relation whatsoever to the cost of rendering the service or measurable benefit derived therefrom and without any provision being made for any standard by which its fairness in any particular case may be tested, or for any accounting of the surplus remaining over and above the actual costs and expenses thereof. In lieu thereof, this surplus remains in the treasury of the American Company for the benefit of all the contributing licensee companies, and machinery is provided for equitable adjustment among them in lieu of a strict accounting by the American Company to each for its distributive share thereof.

11. It has established a single pool of the capital of the licensee companies for the benefit of the Bell System as a whole. The reason for and manner of so doing the American Company itself explained as follows:

"The interdependence of the systems of the various companies was so great that failure to maintain proper service in any one was to the disadvantage of the others as well as to itself. * * * The difficulty at all times for some of the companies to finance themselves, and the impossibility at times for others made some systematic and comprehensive and cooperative financial system obligatory. * * * Through cooperation in financial matters all could be sure of capital to meet all requirements as they arose; one margin of idle capital could be carried for the benefit of all, and advantage could be taken *for all* of favorable financing conditions existing for any one" (R. VII, 2525 [44]).

This pooling is done in the following manner:

(a) The American Company extends financial assistance to the financially weak licensee companies through loans at rates of interest below the open market rates and below its own cost of acquiring capital (R. VI, 2104, 2302). The losses to it caused thereby are absorbed as part of the common costs of the central administration borne by all the licensees, including the Chicago Company. This is true even though the immediate necessity for such assistance is to maintain the efficiency of the highway of communication for the long distance service of the American Company and for the protection of its stock holdings in such borrowing companies, and even though, as already noted, the Chicago Company itself has at no time during its history required or received any such assistance from the American Company;

(b) It has substituted itself for the local banks as the depository for the liquid funds of each licensee company, including the Chicago Company. By so doing, the American Company comes into funds for use by those requiring them and has large balances to be used as a basis for its own current borrowing, in lieu of each licensee itself maintaining balances in local banks for such purpose (R. V, 1808-1809);

(c) It either supplies its own financial credit for the benefit of those licensee companies who, as independent enterprises, can not finance at all, or at least can do so only at prohibitive cost, as in the case of the Central Union, the Missouri Company or the Southwestern Bell, or it uses the available credit of one company to finance other companies or to relieve its own burdens in so doing, as in the case of the use of the credit of the Chicago Company to finance the Central Union (*supra*, 223, 244, 250).

(d) The surplus of contributions by the licensee companies towards the maintenance and expenses of the centralized administration, and the long distance revenues which would in the case of operations between independent companies be distributed in part to pay each licensee company a fair compensation for the use in that service of the local necessary facilities are held in the treasury of the American Company for the benefit of the System as a whole, both to provide current liquid funds for those temporarily requiring the same, and as additional net earnings of the Bell System which, together with the net earnings in the treasury of the licensee companies, are used by the American Company to attract capital to finance the capital requirements of the licensee companies (*infra*, 365).

C.

Statements of American Company.

The extent of its domination and control has been admitted repeatedly by the American Company—statements which have been deliberately made, as it says, so that the users of the services of the Bell System, the investors in the Bell System and the public generally, may know the facts (R. VII, 2619 [15]). These statements are contained in annual reports sent to the Chicago Company and

by it distributed to its own employees (R. VI, 2264) and also distributed by the American Company direct to them as stockholders and to all other stockholders of the American Company.

Bell System Unique.

The American Company says:

"The Bell Telephone System occupies a unique position, and one not generally understood, because it differs so widely in form of organization and in relation to the public and the investors, from other enterprises to which it might be expected to be similar" (R. VII, 2619 [15]).

"By virtue of stock ownership and contracts and the relations which grow out of them, the Bell System operates practically as a single organization offering telephone service to the people of this country without limitation of distance or property ownership" (R. VII, 2644 [7]).

"The service of the Bell System as it stands today is the result of organization and system, in which every individual member is a free, active and responsible agent within his own sphere of action and the limitations of his duties. Each individual feels that he is an essential and important part of the whole, and recognizes his obligatory relation towards all other parts * * *" (R. VII, 2529 [52]).

"'Administration' is centralized, it is legislative, determinative of general subjects, supervisory and judicial, acts alike for all branches and divisions and may be located apart from the seats of action.

"'Operation' is executive. It is the action, the operation supreme as to local questions but responsible to the central administration. It may be separated into divisions or departments, each having operating relations with the other but no lines of authority between them.

"In the Bell System the 'Administration' is in the American Telephone and Telegraph Company, the central company. The 'Operation' is in the Associated Companies, each operating on defined lines in distinct territory, each in fact an operating division and no more" (R. VII, 2519 [36, 37]).

The extent to which the unity of operation has commingled the affairs of the subsidiaries and of the American Company has likewise been admitted repeatedly by the American Company:

> "The American Telephone and Telegraph Company and associated companies constitute one operating entity, and to understand or correctly determine the actual costs and charges of the telephone service and the ultimate distribution of the revenue, their accounts must be consolidated" (R. VII, 2544 [9]).
>
> "To understand or correctly determine the actual costs and charges of the telephone service, and the ultimate distribution of the revenue, a consolidation must be made of the accounts of the Bell Telephone System which includes the American Telephone and Telegraph Company and its associated holding and operating companies in the United States, but does not include connecting independent or sub-license companies, or the Western Electric Company, Inc., except as interest and dividends from these companies are included in non-operating revenues" (R. VII, 2590 [39]).

Strange it is that whereas the American Company, the responsible head of the Bell System and the operator of the unified nationwide service, admits that it cannot determine the actual revenues and expenses of the service of each part of the System even though it has available all of the records thereof, the Chicago Company in the instant case asks the reviewing body to accept its showing of such revenue and expenses as correct for its part of the service, when admittedly it has provided neither access to all the necessary records nor separation of accounts to enable it to make such a showing.

Position of Statutory Court.

The Statutory Court concludes that:

> "The plan of organization, the ownership of property and the method of operation show that the American and Illinois Companies functioned in distinct fields of activity" (R. I, 182).

But the Statutory Court fails to recognize and to give effect to the fact which the American Company itself has admitted and which is conclusive from the record—to-wit: that

> "The Bell System is a well balanced, comprehensive system of intercommunication, in which each exchange district is a center of an intradependent system, each of which is superimposed in part over the other, and each of which must be considered in rate making as a whole" (R. VII, 2540 [48]).
>
> "From a service standpoint, Chicago has no territory. It is part of a system which extends over the United States and Canada—a system which is as much a whole as if all was operated by one company. And nothing can be done in one company which will not affect another" (R. VI, 2078).

The Statutory Court stresses that only three directors of the Chicago Company are officers of the American Company (R. I, 182). But it fails to take into account that eight of the eleven directors in 1923 held qualifying shares of the American Company stock and the total stockholdings of the other three directors were 47 shares of a total outstanding capitalization of 680,000 shares (City Ex. 80, opposite R. VI, 2120). It fails to take into account the fact that only two of the directors were ever active in the affairs of the Chicago Company and that both of these held qualifying stock of the American Company and no personal stock; that of these two, the Chairman of the Board was an ex-Vice-President of the American Company, who, for seven years after the American Company placed him in charge of the Chicago Company, continued on the payroll of the American Company, and part of that time under a secret contract (R. V, 1588, 1589). It fails to take into account the fact that in regard to all departments other than the operating organization the directors have no necessity for, nor can they exercise any power of, discretion, these departments having been transferred to the American Company. It fails

to take into account the fact that in regard to all matters covering the operating organization, (the only department left to the management of the Chicago Company) the subject matter for local discretionary action, is limited narrowly to such action as will in nowise disturb the balance of the Bell System and as will be in harmony with the action of the balance of the Bell System. Over the latter classes of action neither it nor the other subsidiaries have any control, such control being in the American Company.

The lack of personal pecuniary interest on the part of the directors of the Chicago Company has enabled the American Company thus to limit the field of their action without the danger of creating any conflict with them. The question before the directors of the Chicago Company when the 1919 Memorandum was presented, was not the reasonableness of the arrangements therein contained, but whether they were in harmony with the arrangements in the balance of the System, as determined by the American Company; the fact that the American Company prepared them was sufficient evidence that they were. Nor was it material to the directors that the harmonizing of the local long distance arrangement with that of the balance of the System resulted in a sacrifice by the Chicago Company of the right to compensation for the use of its exchange facilities, which right it had previously enjoyed and the amount of which compensation that was being sacrificed the directors did not then know and have never since sought to learn (*supra* 63). Nor was it material to the directors that the harmonizing of the 4½% arrangement with that of the balance of the System imposed on the Chicago Company the obligations to pay for a service which it neither then nor ever before required (the financing service), and for a service for which it was already paying in purchasing merchandise for the Western Electric (the service of making available inventions and improvements embodied in manufactured ap-

paratus), and for a service which it could not transfer legally and the reasonableness of the proposed compensation for which it had no way to test (the service of business management) (*supra,* 210). The standard of uniformity established by the American Company sets the maximum and minimum limits of discretion for the directorate of the Chicago Company in passing on any contracts between it and the American Company. The mere assertion of the standard condemns the legal sanction of any action taken thereunder as the corporate act of the Chicago Company.

D.

Authorities.

An exposition of the law in other or prior cases will serve no useful purpose. The law is clear—the difficulty lies in its application to the *facts* in each case. The relationships created in the Bell System have been before this Court in the *Houston Case,* 259 U. S. 318, and in the *Missouri Case,* 262 U. S. 276. In each of these cases the only *fact upon* which the conclusion of domination and control was sought to be imposed was *the fact of majority stock ownership.* These two decisions and those in which only the same fact appears or is stressed may be dismissed as not applicable to the instant case, where *other and additional* facts are relied on. Of the cases (*Chesapeake & Potomac Tel. Co.* v. *Whitman,* 3 Fed. (2d) 938), wherein the conclusion of domination and control was sought to be imposed on facts of relationship other than the fact of majority stock ownership alone, those which require a showing of facts of bad faith or fraud as the only legitimate basis for such conclusion, may be dismissed as establishing a legal standard contrary to the standard prescribed by this court (*United Fuel Gas Co.* v. *Railroad Commission of Kentucky,* 278 U. S. 300). Where the conclusion of domination and control by the

American Company is tested by the proper legal standard of the use of its stock ownership, and where the conclusion is sought to be imposed on facts of relationship other than the fact of stock ownership, it is obvious that the decision in a particular case will depend mostly upon the array of pertinent facts presented in support thereof. In two recent cases (*People* v. *Michigan Bell Tel. Co.*, 246 Mich. 198, 224 N. W. 438 (1929); *Chesapeake and Potomac Tel. Co. of Virginia* v. *Commonwealth of Virginia*, 147 Va. 43, 136 S.E. 575 (1927)) we find the Supreme Courts of two states holding and concluding that such domination and control exists in the Bell System from classes of facts which were neither as many nor as strong as the facts of relationship shown in the instant case. No case has been found wherein, upon the application of a proper legal standard, a contrary conclusion has been reached from classes of facts essentially similar to those presented in these two cases or in the instant case.

People v. *Michigan Bell Telephone Company.*

In that case wherein *quo warranto* was had by the Attorney General to oust the Michigan Telephone Company from the exercise of its corporate franchise, on the ground that by virtue of its relationship to the American Company, the Michigan Company had ceased to function as a corporation, the Supreme Court entered an ouster order to the extent of eliminating the contract—which had created a relationship which was similar to the 1919 Memorandum in the instant case—, and held that the facts surrounding the operation of the Michigan Company as part of the Central Group, of which the Chicago Company was a member, and the admissions of the American Company contained mostly in its Annual Reports, were in themselves sufficient to establish in law the domination and control by the American Company to which domination and control special legal consequences will attach. The court said:

"A review of all the evidence is convincing that in the Bell System the Michigan Company is merely an operating unit, 'operating on defined lines,' and the lines, to achieve standardization in method, practice, materials and equipment are most minutely defined and are as minutely followed.

The Michigan Company is no more engaged in conducting and carrying on a telephone business than is the ordinary station agent engaged in conducting and carrying on the railroad business of his employer. The agent must use reason and intelligence, and has a certain discretion, but it would be remarkable were his 'lines' as closely defined as are those of the Michigan Company" (246 Mich. 198).

Chesapeake & Potomac Telephone Co. of Virginia v. *Commonwealth of Virginia*

In this case the Supreme Court of ~~Virginia~~ Appeals sustained an order of the Virginia Corporation Commission refusing to allow the increases in rates asked for by the Chesapeake & Potomac Telephone Company, a Bell licensee company. Both the Commission and the Supreme Court of Appeals concluded that domination and control by the American Company over the local company existed in law, and applied the legal consequences thereof in determining (a) the binding effect of contracts between them; (b) the existence of going value; and (c) the proper rate of return.

The classes of facts from which the commission and the court drew their conclusions of domination and control are:

1. Control of the fields of telephone engineering and research work, of the patents under which telephone materials, supplies, apparatus and equipment are manufactured and used, and of the manufacture and sale of such materials, supplies, apparatus and equipment to its licensee companies.

2. Ownership by the American Company of stock in the licensee companies and in the Western Electric as giving

it a virtual monopoly control over the field of telephonic communication in the United States.

3. Admissions of the American Company in its annual reports and in articles by its President.

4. Nature of the long distance arrangement, which was identical with that of the 1919 Arrangement with the Chicago Company.

In the instant case are found all of the classes of facts disclosed in the opinions in the Michigan and Virginia Cases, which caused the tribunals in those cases to conclude that the local companies were reduced by the American Company to mere agencies of its own. In addition to, we have also the following classes of facts:

1. The transfer of allegiance of the employees of the Chicago Company to the Bell System through the operations of the Employees' Benefit Plan and the Employees' Stock Plan (*supra*, 258).

2. The transfer to the American Company of all the departments of the Chicago Company other than the operating organization, and the transfer to the former also of the executive control over such operating organization (*supra* 259).

3. The arbitrary nature of the contribution by the Chicago Company towards the maintenance of the Central Administration by the American Company and the inclusion therein of duplicated charges and charges for services not required or rendered (*supra*, 264).

4. The nature of the relationship of the Chicago Company with the Western Electric (*supra*, 262), with the Bell Telephone Securities Company (*supra*, 262) and with the Central Group (*supra*, 263).

5. The change in the nature of the relationship between the Chicago and American Companies in 1919 to prevent

the disintegration of the control of the property and operations of the former by the latter (*supra*, 264).

6. The facts surrounding the creation of a single pool of capital in which the credit and property of the Chicago Company were included (*supra*, 264).

These classes of facts clearly show that from and after 1918, and during the period under investigation, the Chicago Company had lost its independent identity as an integrated operating business and had become an operative department of the Bell System. Its earnings were partially in its own treasury and partially in the treasury of the American Company. Its organization was partly in its own territory and partly in the General Staff of the American Company to whose support it contributed; the possibility of its acting solely for the best interests of its local community was destroyed in favor of such action as would, in the judgment of the American Company, be for the best interests of the Bell System as a whole; the possibility of its management passing independent judgment on the operations of the company as a public utility was gone.

These classes of facts clearly show the existence of a control by the American Company over the Chicago Company and its services—a control which was rendered possible, it is true, by the ownership of 98% of its stock, but which was not the necessary result of a bona fide exercise of such ownership and which could only have arisen through the use by the American Company of its stock ownership for the purpose of giving it, the American Company, as a corporation, for its own purposes, complete power over the affairs of the Chicago Company, just as if the latter company were a mere department of the American Company. Indeed, such a situation could not have existed had the fact that the two corporations were separate and distinct legal entities been regarded in the administration of the affairs

of the Chicago Company. The failure of the Statutory Court so to hold was contrary to law (*U. S.* v. *Lehigh Valley R. R. Co.*, 220 U. S. 257, 272-3).

E.

Legal Consequences of Domination and Control.

1. 1919 *Memorandum.*

For the purpose of determining how much property is used in local exchange service and how much in long distance service, the contract between the two companies making an arbitrary distribution of such property should be disregarded. But no showing has been made from which the amount can be determined.

In determining what revenues are derived from the use of the local exchange property in Chicago employed in the long distance telephone service, the contract between the two companies arbitrarily determining as between them how much revenue shall be retained by the Chicago Company and so become attributable to such service should be disregarded. From the record, it is impossible to determine the correct amount to which the Chicago Company is entitled.

In determining the charge by the local exchange service to be allocated for the services alleged to be rendered by the American Company, the contract between the two companies which establishes such cost upon the basis of a contract charge should be disregarded and the Chicago Company must show (a) a state of facts from which the law implies a promise to pay; (b) the actual services rendered; (c) the actual costs thereof properly applicable; and (d) a reasonable return upon the capital investment attrib-

utable thereto. But on the record these showings cannot be made.

United Fuel Gas Co. v. *R. R. Commission of Kentucky,* 278 U. S. 300.

Gallatin Natural Gas Co. v. *Public Service Commission* (1927), 79 Mont. 269, 256 P. 373.

Re Coast Gas Co. (Tex. R. C. 1928), P. U. R. 1929 A, 127.

Chesapeake & Potomac Tel. Co. v. *Commonwealth of Virginia,* 147 Va. 43.

People v. *Michigan Bell Tel. Co.* (Mich. 1929), 246 Mich. 198.

2. *Going Value.*

This has been destroyed (*infra,* 363).

3. *Western Electric Relationship.*

Discussion follows on page 278.

4. *Rate of Return.*

Discussion follows on page 357.

WESTERN ELECTRIC RELATIONSHIP.

The Chicago Company Did Not Prove the Fairness of the Cost of a Great Portion of Its Plant.

The Order of August 16, 1923, found that much of the material used by the Chicago Company in the operation of its property is purchased from the Western Electric; that the American Company owns about 98 per cent of the stock of Western Electric and of the Chicago Company; that such ownership leads to close scrutiny; that the record does not contain sufficient facts to pass upon the question of the fairness of the Western Electric prices; that the relationship was not therefore taken into account in the calculations of operating expenses; and that the question of such fairness should be investigated (R. I, 43-44).

The Statutory Court held:

> "The City claims that the plant account upon which the Commission made its findings was inflated and that there is no proper basis in the record for determining original cost. A large part of the purchases entering into plant account were made from the Western Electric Company. The City has failed to support its contention that exorbitant prices were paid to the Western Electric Company. It appears that the average profit for the last fourteen years of the Western Electric Company on its total business had not been in excess of 7 per cent and never above 10 per cent. The evidence does not support a finding that in the transactions with the Western Electric Company there was an abuse of the discretion of the directors and officers of the Illinois Company which constitutes either a fraud or an injury to the public." (R. I, 194).

ERROR OF STATUTORY COURT.

The error of the Statutory Court lies in this: It found that the Bell System was operated to render a unified nation-wide telephone service (R. I, 180). But it failed to take into account and to give effect to those facts

in the record which show that the Western Electric, as part of the Bell System, occupies a unique position in relation to the Chicago Company as a purchaser of its manufactured apparatus. Because of this uniqueness special standards must be applied to determine the fairness of the treatment of one by the other. The standards applied by the Chicago Company and by the Statutory Court did not give effect to such uniqueness and proved nothing as to the reasonableness of the Western Electric prices. They did not apply the special standards provided by the American Company, which did give full effect to such uniqueness. Had application of these special standards been made, the Statutory Court would have found that the rates complained of were constitutionally adequate.

THREEFOLD SIGNIFICANCE OF ERROR OF STATUTORY COURT.

The proper determination of the fairness of the charges to the Chicago Company for Western Electric apparatus has an important bearing on three issues:

1. The estimate by the Chicago Company of the fair value of the Chicago property was predicated upon the application of index numbers to the appraised value of the property as of 1911, plus the book cost of net additions made thereafter (R. I, 195). This estimate the Commission and Statutory Court used as a basis for their findings of fair value. Both the Commission (R. I, 42) and the Statutory Court (R. I, 194) found that a large part of the purchases entering into the plant account of the Chicago property came from the Western Electric. From 1911 to 1923 inclusive the net purchases aggregated $64,000,000* (R. VI, 2062). Such purchases represent over 90% of the total

*Seventy per cent of the net purchases since 1920 are allocated to the Chicago division upon the basis of division of total property, including the Central Union property which was acquired as of that date (R. VI, 2161).

net additions during the period (R. I, 29) and represent about 65% of the book cost of the entire Chicago physical property in service in 1923 (R. I, 194). The purchases during the period 1918-1923 aggregate $34,000,000, of which purchases to the amount of $7,000,000 were made in 1923 (R. VI, 2062). The proper valuation of the Chicago property for rate making purposes depends in large part upon the fairness of the Western Electric prices therefor.

2. The Chicago Company makes a payment to the American Company for the latter's service of making available patents and improvements embodied in patented and non-patentable apparatus manufactured by the Western Electric (*supra*, 201). Most of the same apparatus is also available to non-licensees through their purchases from the Western Electric without the necessity of their making any additional payment to the American Company. The measure of the maximum amount of the payment to the American Company is the differential in favor of the Western Electric prices to the Chicago Company as against the Western Electric prices on a comparable basis to non-licensee purchasers. The determination on a proper basis of the amount of such differential, if any exists, is therefore important in the issue of the propriety of including in the license payment compensation to the American Company for the service of making available patents and improvements embodied in Western Electric apparatus.

3. The portion of the purchase price paid by the Chicago Company for Western Electric apparatus which is included in the former's license payment to the American Company is included in the operating expenses of the Chicago Company; the remainder of the purchase price is included in the capital account. The effect for rate-making purposes of such a method of accounting is to require the rates to provide for 100% of such part of the license payment, and only a proper return on the remainder. On

the other hand, non-licensees include in the capital account the entire charge for Western Electric apparatus; the Chicago Company itself as well as non-licensees include in the capital account the entire purchase price for patented and non-patented apparatus purchased from manufacturers other than from the Western Electric. As to such latter purchases the rates in each community must provide only a proper return on the entire purchase price. Unless an offset is provided, an imposition is created on the telephone users of the Chicago Company by its method of accounting. The Chicago Company and the Statutory Court refused to give effect to the means of offset provided by the American Company itself through making the net earnings from the license payments available to the Bell licensees as a unit for the purpose of attracting capital to them and of maintaining the stability of their securities (*infra*, 377). On the record, the only other possible means of offset is to create a differential in favor of the Western Electric prices to the Chicago Company as against those to non-licensees and as against those of other manufacturers sufficient to absorb the increased burden on the rates of the Chicago Company caused by its own method of accounting. The determination of that differential is important therefore in connection with the issue of the propriety of the amount of license payment to cover the service of the American Company of making available patents and improvements embodied in Western Electric apparatus, which can be properly included in operating expenses.

SUMMARY STATEMENT OF CITY'S CONTENTIONS.

The City contends that the Statutory Court erred in finding that the Western Electric prices to the Chicago Company were fair because:

I. The Western Electric as part of the Bell System occupies a unique position in relation to the Chicago Company as a purchaser of its manufactured apparatus.

II. The standards applied by the Chicago Company and by the Statutory Court to determine the fairness of the charges to the former for Western Electric apparatus cannot and do not determine their fairness.

III. The Chicago Company and the Statutory Court failed to apply the standards provided by the American Company and submitted by the City to prevent imposition on the Chicago Exchange telephone users through the purchase by the Chicago Company of Western Electric apparatus.

In support of its contention numbered (I) the City offers the following:

A. Since 1908 the Western Electric has functioned as the Manufacturing Department of the Bell System.

B. The relationship of the Western Electric to the Bell System has eliminated in the manufacture and sale of its apparatus to the Bell licensees, including the Chicago Company, many costly operations which are necessary for the sale of the same apparatus to non-licensee customers and for sale of similar apparatus distributed by other manufacturers.

C. The Chicago Company pays to the American Company a portion of the purchase price paid for Western Electric apparatus.

D. For rate-making purposes, that portion of the total purchase price for Western Electric apparatus which is

included in the license payment made to the American Company is charged to the operating expenses of the Chicago Company instead of to its capital account.

In support of its contention numbered (II) the City offers the following:

A. The applied standards fail to take into account and to give effect to the portion of the purchase price for Western Electric apparatus included in the license payment of the Chicago Company to the American Company.

B. The applied standards assume but do not prove that all of the net earnings from the sale of Western Electric apparatus to the Chicago Company are to be found in the portion of the purchase price paid to the Western Electric and not in the portion paid to the American Company, and assume but do not prove that such net earnings are no more than reasonable.

C. The results from the applied standards prove nothing as to the reasonableness of the Western Electric prices.

In support of its contention numbered (III) the City offers the following:

A. The American Company has provided a substitute for a strict accounting to prove the fairness of the purchase price paid by the Chicago Company for Western Electric apparatus, and of the burden imposed on the Chicago Company's rates by its method of accounting for such purchase price. Such substitute and offset are contained in the machinery by which the benefits of the net earnings from such purchases received by the American Company and by the Western Electric are made available to the Chicago Company as a department of the American Company to enable the Chicago Company to attract capital and to maintain the stability of its securities.

B. By applying the special standard provided by the American Company, the Statutory Court could have found that the net earnings from the operations of the Chicago Exchange under the rates complained of are more than those to which the Chicago Company is constitutionally entitled.

DISCUSSION AS TO CONTENTION NUMBERED I.

I.

THE WESTERN ELECTRIC AS PART OF THE BELL SYSTEM OCCUPIES A UNIQUE POSITION IN RELATION TO THE CHICAGO COMPANY AS A PURCHASER OF ITS MANUFACTURED APPARATUS.

A.

Since 1908 the Western Electric has functioned as the manufacturing department of the Bell System.

Beginning with 1908 a definite program was undertaken by the American Company to readjust the operations of the Western Electric to fit in with its plan of unifying the Bell System into one operating entity, with the American Company as its responsible head (*supra,* 257), in which organization the Western Electric was to serve as the manufacturing department* (R. VII, 2457 (15, 16)). As part of this program: (a) the relationship between the Western Electric and each licensee was made dependent upon the continued relationship between such licensee and the American Company and between the Western Electric and the Amer-

*To avoid questions of conflicting interests the American Company acquired a majority of the large holdings not theretofore held by it, increasing its stockholdings to 80% of the outstanding stock of the Western Electric (R. VII., 2457 (15): R. VI., 2064). This percentage steadily increased to 98.29% by 1923 (R. VI., 2283).

ican Company (R. VI, 2331); (b) through its policy of standardization, the American Company confined practically all purchases of apparatus for its licensees to the Western Electric, the American Company determining the necessity for and utility of such purchases and specifying the general character thereof (R. V, 1590, 1592); (c) all contacts between the Western Electric and the licensees were arranged through the American Company, the latter acting at the same time as the selling agent for the Western Electric and as the purchasing agent for each licensee (*supra,* 239); (Pltf.'s Ex. 64, opposite R. IV, 1556); (d) through the policy of the American Company of budgeting at least a year in advance the requirements of its licensees the Western Electric had available the information of such requirements far in advance of the actual orders (R. III, 1117); (e) through the use of the Bell System of a single pool of capital to finance each and every part of its development (*supra,* 264), the credit of each licensee was in effect supported by the resources of every other licensee; (f) the Electrical and Mechanical Departments of the Western Electric and the equivalent departments of the American Company were consolidated into one organization (R. VII, 2570 (20)); (g) the allegiance of the employees of the Western Electric was transferred from it to the Bell System as a whole (R. VI, 2006); and (h) the skilled personnel of the Western Electric and of the licensees was made available to each other under the direction of the American Company (R. VI, 2006).

B.

The relationship of the Western Electric to the Bell System has eliminated in the manufacture and sale of its apparatus to the Bell licensees, including the Chicago Company, many costly operations which are necessary for the sale of the same apparatus to non-licensee customers and for the sale of similar apparatus distributed by other manufacturers.

The relationship with the Bell System above described gave to the Western Electric the advantage "of a ready-made business with none of the ordinary drawbacks, expenses and risks that other manufacturing companies have" (R. VII, 2457 (15)). In particular it gave to the Western Electric: (a) an established continuing business with the operating companies of the Bell System on a monopoly basis, without the necessity of the Western Electric's incurring any expense in the establishment of such business (R. III, 1107, 1109); (b) the ability to purchase raw material in large quantity so as to get the maximum discounts; (c) the ability to manufacture products in large quantity upon advance orders, thereby avoiding the peaks and ebbs in manufacture and thereby receiving the full benefit of all economies of quantity production (R. III, 1117, 1118; R. VII, 2456 (14)); (d) the ability to eliminate selling expense in dealing with the Bell System, "which in the ordinary manufacturing business absorbs a large percentage of the manufacturing profits," and which was estimated in the instant case to absorb from 10% to 15% of the gross selling price of manufactured products (R. VII, 2456 (14); R. III, 1111); (e) the ability to eliminate bad debts; (f) the ability to receive from the research and development departments of the American Company (maintained at the expense of the licensee) advice and assistance covering the necessity for and utility of various classes of apparatus and the specifi-

cations thereof for manufacture (R. III, 1083, Pltf.'s Ex. 64, opposite R. IV, 1556).

As the Western Electric is entitled to receive from its dealings with the Bell licensees only reasonable net earnings, the sales price to them should cover not more than the actual costs to the Western Electric of manufacturing and of distribution plus an amount sufficient to yield such reasonable net earnings. Unless the factors of advantage are otherwise accounted for, the Western Electric prices to Bell licensees will necessarily be lower than the Western Electric prices for the same apparatus to non-licensees; similarly Western Electric prices to Bell licensees will necessarily be lower than the sale prices of similar apparatus distributed by other manufacturers who do not enjoy the advantages held by the Western Electric.

C.

The Chicago Company pays to the American Company a portion of the purchase price paid for Western Electric apparatus.

Non-licensees make only one payment for any patented and non-patentable items manufactured by the Western Electric. The Chicago Company and non-licensees make only one payment to manufacturers other than the Western Electric for patented and non-patentable merchandise. The single payment in either case naturally absorbs all royalties for the use of patents and/or all compensation for developments embodied in such items. The Chicago Company, on the other hand, not only pays the Western Electric price for the same items but also includes as part of its license payment to the latter, compensation covering royalties for the use of patents owned and/or controlled by the American Company and/or by the Western Electric and covering improvements embodied in such items (*supra,* 280).

D.

For rate-making purposes, that portion of the total purchase price for Western Electric apparatus which is included in the license payment made to the American Company is charged to the operating expenses of the Chicago Company instead of to its capital account.

As already noted, no part of the price paid by the non-licensees for apparatus manufactured by the Western Electric is charged to their operating expenses, while that portion of the purchase price paid by the Chicago Company for Western Electric apparatus which is included in the license payment to the American Company properly allocable thereto is charged to operating expense (*supra*, 215) Assume that the proper rate of return which telephone rates must cover is 6%, and assume that the payment by non-licensees to the Western Electric and by the Chicago Company to the American Company to cover royalties and developments embodied in Western Electric apparatus is in each case the same. Under such circumstances the rates in territories of non-licensees must provide earnings to cover only 6% of such payment while the rates in the territory of the Chicago Company must provide earnings to cover the full 100% of the same payment, or 16 2/3 times the amount required to be provided by the rates of non-licensees. In the absence of any other method of offset to the discrimination against the users of the Chicago Company's services, it is necessary that, for every dollar of payment by the Chicago Company to the American Company to cover royalties and developments embodied in Western Electric apparatus, the Western Electric price to the Chicago Company should be at least $15.50 cheaper than the Western Electric prices to non-licensees for the same apparatus.

DISCUSSION AS TO CONTENTION NUMBERED II.

II.

THE STANDARDS APPLIED BY THE CHICAGO COMPANY AND BY THE STATUTORY COURT TO DETERMINE THE FAIRNESS OF THE CHARGES TO THE FORMER FOR WESTERN ELECTRIC APPARATUS CANNOT AND DO NOT DETERMINE THEIR FAIRNESS

A.

The applied standards fail to take into account and to give effect to the portion of the purchase price for Western Electric apparatus included in the license payment of the Chicago Company to the American Company.

From the analysis already given it is apparent that an adequate standard to test the fairness of the charges to the Chicago Company for Western Electric apparatus must comprise the following factors:

1. It must take into account, as part of the charges to the Chicago Company for Western Electric apparatus, the portion of the purchase price included in the license payment to the American Company.

2. It must reflect the effect on that portion of the purchase price paid to the Western Electric of the elimination of the many items of cost of production and of distribution resulting from the Western Electric relationship to the Bell System.

3. It must provide an offset to the undue burden on rates of the Chicago Company through the inclusion, as part of its operating expenses of the portion of the purchase price for Western Electric apparatus included in the license payment to the American Company.

The Chicago Company applied three classes of tests: (1) a comparison of the Western Electric prices to it and to non-licensees for manufactured apparatus (R. IV, 1557); (2) a comparison of the Western Electric prices to licensees and to non-licensees (Pl. Ex. 70, opposite R. IV, 1566); and (3) a comparison of the Western Electric prices to licensees with those of other manufacturers (R. III, 1082-3).

None of these tests takes into account or gives effect to the fact that a portion of the purchase price for Western Electric apparatus is included in the license payment to the American Company. They use only one portion of the payment by the Chicago Company for Western Electric apparatus as a basis for determination that the entire payment is reasonable. They fail to take into account the difference in the effect for rate-making purposes between the part of the license payment by the Chicago Company to cover royalities and developments embodied in apparatus which is included in operating expenses, and the equivalent portion of the payments by non-licensees for Western Electric apparatus which covers the same item and which is included in capital account. The tests are fatally defective.

B.

The applied standards assume but do not prove that all of the net earnings from the sale of Western Electric apparatus to the Chicago Company are to be found in the portion of the purchase price paid to the Western Electric and not in the portion paid to the American Company, and assume but do not prove that such net earnings are no more than reasonable.

The witness testifying on behalf of the Chicago Company admitted the reduction in cost of production and of distribution of Western Electric apparatus to Bell licensees by vir-

tue of its relationship to the Bell System (R. III, 1110). No study was made to measure the amount of such reduction (R. III, 1109). In the application of the tests to determine the fairness of the charges to the Chicago Company for Western Electric apparatus the witness adopted as the means of accounting for the amount of such reduced cost of production and of distribution the assumption that the net earnings of the Western Electric were no more than reasonable (R. III, 1108, 1120). From this assumption, it was urged, the Western Electric prices to the Chicago Company over and above the amount of such net earnings necessarily included *only* the actual cost of production and of distribution actually entering into such apparatus. The prices would then be on a comparable basis with those charged to non-licensees and with those of other manufacturers whose prices were compared.

Therefore *the tests applied by the Chicago Company all* included *as one essential link the proof by the Chicago Company that the net earnings of the Western Electric properly allocable to licensee business exclusively are no more than reasonable.* The tests likewise include as another essential link the proof that no net earnings are contained in that portion of the purchase price for Western Electric apparatus included in the license payment to the American Company.*

The Chicago Company failed in its proofs.

No evidence was offered on behalf of the Chicago Company of the net earnings of the Western Electric from licensee business exclusively, although the necessary data was available to the executive of the American Company

* In the instant case the Chicago Company itself assumed the burden of proving the reasonableness of the Western Electric's net earnings from Bell licensee business. The instant case, therefore, does not present the issue presented in the *Houston Case* (259 U. S. 318, *supra*, 242), wherein the City of Houston sought to impose the burden on the Southwestern Bell to show the net earnings of the Western Electric as the test of the fairness of the charge by the latter.

who made the above assumption and whose duty it was, as he claimed, to protect the interests of the Bell licensees in their dealings with the Western Electric (R. III, 1078, 1109). For some unaccountable reason the Chicago Company made no effort to show the net earnings of the Western Electric from licensee business and apparently considered that such a showing was not necessary (R. III, 1103).

The Statutory Court based its conclusion of the reasonableness of the charges to the Chicago Company for Western Electric apparatus upon its finding "that the average profit for the last fourteen years of the Western Electric Company's total business has not been in excess of 7 per cent and never above 10 per cent" (R. I, 194). But there is no evidence to support the finding, and there is no necessary relation between the finding and the conclusion. The entire evidence of Western Electric earnings from its total business on which the Statutory Court relies consists of an estimate made by a witness testifying on behalf of the Chicago Company during the course of his cross-examination by the City. He had no available supporting data at hand (R. III, 1130); and he was neither an employee of the Western Electric nor fully conversant with its affairs (R. III, 1131).

The Western Electric, during the fourteen-year period 1915-1928, not only manufactured apparatus for Bell System licensees but engaged in other operations. It sold telephone apparatus to non-licensees (R. III, 1081, 2); it manufactured electrical supplies for sale to the public directly and through subsidiary companies (R. III, 1083); it manufactured orthophonic devices as exemplified by the Victor Talking Machine and the improved records that are used with it; it manufactured the talking motion picture of which the Vitaphone and Movietone are trade names (R. III, 1084); it and the American Company had jointly operated departments

(R. III, 1083). There is nothing in the record to show the net earnings during such period from the other operations of the Western Electric exclusive of operations with Bell licensees; to show that such other net earnings were not below the average at any time during such period; to show that the common expenses incurred and the common capital used in the different classes of business were properly apportioned; to show that the common expenses of the Western Electric and the American Company in their joint operations were properly apportioned; to show the basis on which the value of the net assets was determined, on which basis the net return was estimated; or to show that neither the whole nor any part of the savings in cost of production and of distribution in sales to Bell licensees was passed on to the other operations of the Western Electric to meet or to beat competition therein. In the absence of such showings the assumption that the average net earnings on the entire business necessarily represents the net earnings from the licensee business alone is pure speculation.

The Statutory Court found the reasonableness of the charges to the Chicago Company by the Western Electric by considering only the net earnings of the latter company. It excluded from consideration the net earnings of the Western Electric sales, if any, included in that portion of the purchase price for such apparatus which is included in the license payment to the American Company. There is no warrant for such exclusion. Since 1882 the Western Electric has agreed to reimburse the American Company the entire cost (including royalties) of any inventions embodied in telephone apparatus manufactured by the Western Electric but developed by the American Company or acquired by the latter from sources other than from the Western Electric (*supra*, 157). It has agreed also to make no charge to the American Company for the exclusive right and license granted to the latter to use and sell and to license

others to use telephone apparatus manufactured by the Western Electric under patents owned and/or controlled by the latter.** Therefore, the part of the license payment by the Chicago Company to the American Company allocable to royalties for patents, developments, and improvements embodied in Western Electric apparatus represents *net profit* to its recipient. Such net profit just as truly represents net earnings properly attributable to Bell licensees' purchases of Western Electric apparatus as do the net earnings revealed by the earning statements of the Western Electric. Both the Chicago Company and the Statutory Court failed to take into account and to give effect to such net earnings in the treasury of the American Company.

The proof of the net earnings derived from charges to the Chicago Company for Western Electric apparatus was an essential link in the standards applied by the former to show the fairness of such charges. The Chicago Company failed to make good on its proof.

C.

The results from the applied standards prove nothing as to the reasonableness of the Western Electric prices.

As all of the tests applied by the Chicago Company are subject to the same fatal objections we have selected the results of one of them for discussion.

The Chicago Company purported to show that on Western Electric charges to it for apparatus and cable in 1921 aggregating $6,304,596 the differential in favor of such charges as against the charges of competing manufacturers for the same class of material was $497,023 (R. IV, 1560).

**74% of all patents owned or controlled by the American Company in 1923 belonged to the Western Electric (R. III, 1007).

The showing was predicated upon the assumption which was not proved that the net earnings of the Western Electric derived therefrom were no more than reasonable.*

On the basis of a 6% rate of return, this differential, if correct, favorably affected the required earnings of the Chicago Company to the extent of $30,000. Such saving, however, would be offset by the allocation of less than $32,000 from the license payment to the American Company for that year as compensation for royalties and for the service of the American Company of developing and making available improvements embodied in Western Electric apparatus. The differential of $497,023 represents 7.88% of the total purchases investigated (R. IV, 1560); the payment to the American Company of $32,000 represents less than 2¼% of the total license payment of $1,529,443.46 made by the Chicago Exchange to the American Company in 1921 (R. VI, 2083). $630,471.82 of the license payment covers telephone rental service.** The balance—$898,961—is allocable to financing service, to the service of business management, and to the service of making available patents and improvements embodied in Western Electric apparatus. The payment of $32,000 is 3½% of such balance. In view of the negligible character of the financial service to the Chicago Company (*supra*, 219), is it reasonable to suppose that less than $32,000 of such balance is allocable to the service of making available patents and improvements embodied in Western Electric apparatus? If the assumption is reasonable, it necessarily

*The showing was predicated on another assumption which destroys its value. Only 46% of the purchases were comparable; 48% were non-competitive (R. IV, 1557). The witness assumed that the non-competitive prices were fair because the competitive items showed a slight margin in favor of Western Electric prices (R. IV, 1557). Such assumption is contrary to the elementary business principle that a manufacturer will make up on non-competitive items what he sacrifices to need or to destroy competition on competitive items.

**The average number of stations in service in the Chicago Exchange in 1921 was 589,226 (R. VI, 2084); the per station rental for instruments is calculated at $1.07 on the basis of the allocation made for 1923 by the Chicago Company in the instant case (R. III, 1044).

destroys the importance of the service itself in testing the fairness of the license payment to the American Company. Yet practically the entire proof to support that portion of the license payment which did not cover telephone rentals was predicted on the importance of such service (R. III, 1044). The test to show the reasonableness of the charge in 1921 for Western Electric apparatus proves nothing as to the reasonableness of the charges to the Chicago Company for Western Electric apparatus.

The test, however, possesses significance on another issue; it shows that even if the net earnings of the Western Electric from Bell licensee business are no more than reasonable, the margin, if any, in favor of the Western Electric prices to the Chicago Company as against those charged to non-licensees, is so small as to preclude any but a negligible payment to the American Company for the service of the latter of making available to the Chicago Company patents and improvements embodied in Western Electric apparatus.

Wherefore we submit:

1. The Chicago Company failed to prove and the Statutory Court erred in finding that the book cost of a large portion of the total physical property used in the telephone service in Chicago represented the fair cost for such property. Based on such cost the fair value of such property for rate-making purposes was calculated. Clearly, by its failure of proof, the Chicago Company has destroyed the possibility of the determination by any reviewing authority of the inadequacy of the rates complained of.

2. The results of the tests applied by the Chicago Company to ascertain the fairness of the Western Electric prices have destroyed the possibility of using the service of the American Company of making available patents and improvements embodied in Western Electric apparatus to support the license payment to the American Company in 1923 of $1,015,243 (*supra,* 232).

DISCUSSION AS TO CONTENTION NUMBERED III.

III.

THE CHICAGO COMPANY AND THE STATUTORY COURT FAILED TO APPLY THE STANDARDS PROVIDED BY THE AMERICAN COMPANY AND SUBMITTED BY THE CITY TO PREVENT IMPOSITION ON THE CHICAGO EXCHANGE TELEPHONE USERS THROUGH THE PURCHASE BY THE CHICAGO COMPANY OF WESTERN ELECTRIC APPARATUS.

A.

The American Company has provided a substitute for a strict accounting to prove the fairness of the purchase price paid by the Chicago Company for Western Electric apparatus, and of the burden imposed on the Chicago Company's rates by its method of accounting for such purchase price. Such substitute and offset are contained in the machinery by which the benefits of the net earnings from such purchases received by the American Company and by the Western Electric are made available to the Chicago Company as a department of the American Company to enable the Chicago Company to attract capital and to maintain the stability of its securities.

1. The license payment by each licensee to the American Company is established on the same basis of 4½% of its gross operating earnings (R. V, 1811), and each licensee makes the same uniform payment to the Western Electric for the same item (R. VI, 2070). The Bell licensees are therefore the only purchasers of Western Electric apparatus who hold a relation to it and to the American Company similar to the relation to them held by the Chicago

Company. The application of the test of uniformity of payment to the Western Electric and to the American Company by each licensee will therefore prevent discrimination of treatment between them.

2. All of the licensees, as part of the Bell System, are responsible for the reductions in costs of production and of distribution to them of the Western Electric products. The uniform Western Electric prices to the licensees reflect without discrimination any savings in fact reflected in the Western Electric prices. They do not, however, reflect the extent of the savings. To provide the machinery whereby each licensee will be assured the full benefit of such savings without strict accounting to each licensee for its share thereof, the American Company, as the financing department of the Bell System, has made available for the benefit of all of its licensees as a unit in financing their requirements and in maintaining the stability of their securities, the cash dividends paid by it to the American Company (*infra*, 376).

3. The American Company has not made a separation of the license payments by the licensees to allocate a portion thereof to the services of making available patents and improvements embodied in Western Electric apparatus. Nor has it apportioned to each licensee its share of the allocable portion of the license payment attributable to such apparatus. In lieu thereof the American Company, as the financing department of the Bell System, has made available the net earnings from the license payments for the benefit of all of its licensees as a unit in financing their requirements and in maintaining the stability of their securities (*infra*, 377). By so doing it also offsets the undue burden on the rates established by such licensees caused by the fact that such licensees include in the operating expenses instead of in the capital account the part of the license payment attributable to Western Electric apparatus.

B.

By applying the special standard provided by the American Company, the Statutory Court could have found that the net earnings from the operations of the Chicago Exchange, under the rates complained of, are more than those to which the Chicago Company is constitutionally entitled.

Since the Chicago Company, as a licensee, has available to finance its needs both the earnings from its own operations and the earnings of the Western Electric and of the American Company, the minimum amount of net earnings which the Chicago Company must earn from its own operations to attract capital to it and to maintain the stability of its securities is necessarily less than the minimum amount of such net earnings which non-licensees or other independent enterprises must earn for the same purpose. It is obvious that the yardstick applicable to test the inadequacy of such latter net earnings can not be used to test the inadequacy of net earnings of the Chicago Company.

On the issue of confiscation the Statutory Court applied to the net earnings of the Chicago operations the yardstick for inadequate returns applicable to the net earnings of non-licensees and to other independent enterprises. By so doing, the Statutory Court failed to take into account and to give effect to the right of the Chicago Company to participate in the manner already described in the benefits of the Bell System earnings in the treasuries of the Western Electric and of the American Company.

In our discussion on Rate of Return (*infra*, 378), we prove conclusively that had the Statutory Court applied the special yardstick provided by the American Company and submitted by the City as the proper yardstick to test

the adequacy of that portion of the net earnings of the Chicago Company found in its treasury, it would have held that the net earnings from the operations of the Chicago Exchange under the Order of August 16, 1923, were more than those to which it was constitutionally entitled. Its failure so to do was error.

PART II.

VALUATION.

The Statutory Court increased by $10,214,298 the valuation found by the Commission as the rate base.

The Statutory Court held:

> "The valuation of $96,000,000 found by the Commission, as of December 31, 1922, or $106,000,000 as of June 30, 1923, if the net additions from January 1, 1923, to June 30, 1923, are added, is clearly insufficient, and shows that proper consideration was not given to the element of reproduction cost new. (*St. Louis and O'Fallon R. Co.* v. *U. S.*, 279 U. S. 461, 484; *McCardle* v. *Indianapolis Water Co.*, 272 U. S. 400, 410, 411; *Bluefield Waterworks and Improvement Co.* v. *Public Service Commission*, 262 U. S. 679, 691, 692; *Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission, supra.*)
>
> Certainly a valuation of less than $125,000,000 (estimating the depreciation at 10%) would amount to confiscation." (R. I, 197).

The Commission and the Statutory Court each made its own finding and valuation of the undepreciated reproduction cost new of the Chicago physical plant, exclusive of working capital, going value, materials and supplies and work in progress. The following table shows the relation of such findings and valuations made on the basis just stated, to the book cost and to the Chicago Company's estimate of the reproduction cost new on the same basis as of December 31, 1922, and as of June 30, 1923.

FINDING OF REPRODUCTION COST NEW AND VALUATION BY COMMISSION AND BY STATUTORY COURT RELATED TO CHICAGO COMPANY'S ESTIMATE OF REPRODUCTION COST NEW AND TO BOOK COST.*

AS OF DEC. 31, 1922.

	Value	Ratio of findings, valuations and estimate of reproduction cost new to book cost	Ratio of valuations to findings of reproduction cost new	Ratio of findings and valuations to Company's estimate of reproduction Cost New	Ratio of percentage of increase over book cost included in findings and valuations to percentage of increase claimed by Company
		B	C	D	E
1. Book cost	$ 85,687,816 (R. I, 18)	100%			
Reproduction Cost New					
2. Company's Estimate.	141,759,647 (R. I, 20)	165%			
3. Com. Finding	128,769,000 (R. I, 43)	150%	100%	90.8%	76.8%
4. Com. Valuation	110,553,128 (R. I, 44)	129%	85.9%	78%	44.3%
5. Stat. Court Finding.	135,061,802 (R. I, 195)	158%	100%	95.3%	88.1%
6. Stat. Court Valuation	120,767,426 (R. I, 197)	141%	89.4%	85.2%	62.6%

AS OF JUNE 30, 1923.

		G	H	I	J
1. Book cost	$ 95,626,014	100%			
Reproduction Cost New					
2. Company's Estimate.	145,248,344 (R.IV,1155)	152%			
3. Com. Finding	138,707,198 (R. I, 197)	145%	100%	95.5%	86.8%
4. Com. Valuation	120,491,326 (R. I, 197)	126%	86.9%	83%	50.1%
5. Stat. Court Finding.	145,000,000 (R. I, 195)	152%	100%	100%	100%
6. Stat. Court Valuation	130,705,624 (R. I, 197)	137%	90.1%	90%	70.7%

As shown on the table, the Commission's valuation as of December 31, 1922, was 29% above book cost; the Statutory Court's minimum valuation was 41% above book cost. The Commission's valuation represented 85.9% of its own finding of reproduction cost new; the Statutory Court's

*The valuation as a rate base found by the Commission and that found by the Statutory Court each included $7,196,872 for working capital and going value. They differed, however, in the amount of depreciation deducted, the former deducting the full amount of $26,000,000 shown by the depreciation reserve, and the latter deducting only $13,090,000, being 10% of its valuation of physical plant. The determination of the consideration given to the element of reproduction cost new can be made only by analyzing each undepreciated valuation after deducting therefrom working capital, going value and work in progress. The calculations are on such basis.

valuation represented 89.4% of its own finding of minimum reproduction cost new. The Commission's finding of reproduction cost new represented 90.8% and its valuation represented 78% of the Chicago Company's estimate of reproduction cost new; the Statutory Court's finding of reproduction cost new represented 95.3% and its valuation represented 85.2% of the Chicago Company's estimate of reproduction cost new. The increase above book cost included in the Commission's finding of reproduction cost new represented 76.8% and the increase included in its valuation represented 44.3% of the increase above book cost included in the Chicago Company's estimate; the increase above book cost included in the Statutory Court's minimum finding of reproduction cost new represented 88.1% and the increase included in its minimum valuation represented 62.6% of the increase above book cost included in the Chicago Company's estimate.

Conceivably the Statutory Court's holding that the Commission's valuation was void could be on one or both of the following grounds:

(1) The Commission's valuation was void because it gave effect to 85.9% of its own finding of reproduction cost new as of December 31, 1922, instead of the minimum of 89.4% which the Statutory Court included in its valuation; and/or (2) the Commission's finding of reproduction cost new was void because it did not include the net additions for 1922.

ERROR OF STATUTORY COURT.

We contend that the Statutory Court erred because:

I. The acceptance by the Commission of 85.9% of its own finding of reproduction cost new in valuing the Chicago property instead of 89.4% thereof does not make such valuation void.

II. The conclusion that the Commission overlooked the net additions for 1922 is based upon four assumptions which are untrue.

SUMMARY STATEMENT OF CITY'S CONTENTIONS.

In support of contention numbered I we offer the following:

A. The law does not require the Commission to give any specified minimum weight to the element of reproduction cost new in valuing property for rate-making purposes.

B. The inclusion by the Commission in its valuation as of December 31, 1922, of 85.9% of its own finding of reproduction cost new shows that it intended to and in fact did give proper consideration to the element of reproduction cost new.

In support of contention numbered II we offer the following:

A. The Statutory Court erroneously assumes that the price levels of December 31, 1921, did not decline during 1922.

B. The Statutory Court erroneously assumes that the Commission did or was legally bound to accept at its full face value the Chicago Company's estimate of reproduction cost new of the Chicago physical plant, excluding overheads, as of December 31, 1921, as extended to December 31, 1922, as the sole basis for the Commission's finding of reproduction cost new of the same plant as of the latter date.

C. The Statutory Court erroneously assumes that the price levels as of December 31, 1922, did not decline to June 30, 1923.

D. The Statutory Court erroneously assumes that the Commission did accept or was legally bound to accept at

its full face value the Chicago Company's estimate of reproduction cost new as of June 30, 1923, of the Chicago physical plant, **including** overheads, as the sole basis for the Commission's finding of reproduction cost new as of that date.

DISCUSSION AS TO CONTENTION NUMBERED I.

I.

THE ACCEPTANCE BY THE COMMISSION OF 85.9% OF ITS OWN FINDING OF REPRODUCTION COST NEW IN VALUING THE CHICAGO PROPERTY INSTEAD OF 89.4% THEREOF DOES NOT MAKE SUCH VALUATION VOID.

A.

The law does not require the Commission to give any specified minimum weight to the element of reproduction cost new in valuing property for rate-making purposes.

To comply with constitutional requirements, a valuation for rate-making purposes may not deliberately disregard consideration of the element of reproduction cost new (*St. Louis & O'Fallon R. Co.* v. *U. S.*, 279 U. S. 461, 487). However, that element is only one of many elements entering into the valuation of property. But this Court has never held that the element of reproduction cost new or any other one element entering into the valuation of property shall be given a fixed or minimum weight in determining the proper valuation as of a given date. The folly of attaching any fixed weight to the element of reproduction cost new in the instant case is clear. The Commission directed attention to the fact that the estimates by the Chicago Company showed that during the last five months of 1921 prices had declined

approximately 11%. It emphasized that fact as showing "the lack of stability of the reproduction cost theory and the consequent danger of relying entirely thereon when determining the value of a property." (R. I, 20). The Commission clearly stated the basis upon which its valuation was arrived at (R. I. 17):

> "Some courts have said that the value is to be fixed as of the date of the inquiry. This may be true as a strictly legal proposition, but in considering all of the economic laws governing the perpetuity of a company in service, a fair value must be so fixed as will, within reasonable conditions in the future, furnish a safe and reliable valuation both for the flotation of securities, for the security of capital invested and for furnishing a field for the investment of new finances in the future development of the company. In this regard not only must the Commission be governed by considerations of a value and rate not subject to the criticisms of confiscation but it must also consider trend of prices, original cost, reproduction cost, and all other considerations which may in any manner assist the Commission in fixing such a value which, in the fluctuation of prices and cost reasonably to be expected in the immediate future, will carry the company through on a safe, sound and economic financial basis."

The Chicago Company's estimate of reproduction cost new was based upon a theoretical construction period of nine years (R. I, 22). If related back from 1922 the nine-year period shows rising prices during the early part thereof, with a short decline at the end of the period. If extended forward from 1922 the nine-year period shows a short decline for part of the period, constant price levels for another part and an abrupt decline at the present time, far beyond that which a few years ago seemed probable (Plaintiff's Exhibit 44, opposite R. IV, 1426). The Commission informed by experience in dealing with this intricate subject should be given the fullest discretionary latitude in attaching weight to any given fact as a basis for its conclusion of value. The Statutory Court itself acted in vio-

lation of law in attempting to provide a yardstick by which the effect of one fact among many should be measured by the Commission, even though such yardstick may not bear relation to the probative force of that fact.

B.

The inclusion by the Commission in its valuation as of December 31, 1922, of 85.9% of its own finding of reproduction cost new shows that it intended to and in fact did give proper consideration to the element of reproduction cost new.

The Commission's valuation represented an increase of 29% above book cost. Among other facts, the following were known to the Commission: Over 80% of the entire physical plant was added after 1911 (R. I, 29); the additions from 1918 to 1923 aggregated approximately the entire physical plant as of 1911 (R. I, 29); the Chicago Company was then operating under rates which were established with its own consent on the basis of the use of the book cost of its structural plant to reflect the fair value thereof because, as it contended, over five-sixths of the plant had been added since 1911 (R. IV, 1289)*: the Commission in 1923 was looking into an uncharted future with a decline in prices already appearing imminent. In the light of such facts, among others, the Commission included for rate-making purposes the full effect of the factor of reproduction cost new as it appeared to it in 1923, excepting only 14.1% thereof. Who can say that the Commission acted so unreasonably as to make its valuation void? The mere fact that the Commission failed to give the ef-

*The Chicago Company estimated the reproduction cost new of the undepreciated structural plant exclusive of construction work in progress and working capital on July 31, 1919, at $95,744,419; the Commission found the reproduction cost new as of the same date for the same plant to be the same amount; the book cost was $65,178,006 (R. IV, 1287, 1292, 1294).

fect to evidence which the Statutory Court considers proper is no ground for setting aside the Commission's order (*St. Louis and O'Fallon R. Co.* v. *United States*, 279 U. S. 461, 493).

DISCUSSION AS TO CONTENTION NUMBERED II.

II.

THE CONCLUSION THAT THE COMMISSION OVERLOOKED THE NET ADDITIONS FOR 1922 IS BASED UPON FOUR ASSUMPTIONS WHICH ARE UNTRUE.

A.

The Statutory Court erroneously assumes that the price levels of December 31, 1921, did not decline during 1922.

The Statutory Court holds that there is no rational basis in the record for the finding by the Commission of $128,769,000 as reproduction cost new unless there is added $8,292,869, the amount of the net additions which the court held the Commission obviously overlooked (R. I, 195). In the absence of a showing that the Commission's finding was based on no evidence whatsoever or on insufficient evidence, the finding will not be set aside (*Banton* v. *Belt Line R. Corp.*, 268 U. S. 413). Neither the record on which the Commission's finding was based nor the other factual data of general knowledge, or otherwise, on which it could rely legally in making its own finding, were before the Statutory Court. Nor does the latter, in its own opinion, state what facts in the record make it appear obvious, as it holds, that the Commission overlooked the net additions for the year 1922.

The Statutory Court apparently accepted the argument made by the Chicago Company based upon certain deduc-

tions from the face of the Commission's Order of August 16, 1923. The Order shows that the Chicago Company's estimate of reproduction cost new as of December 31, 1921, covering the items of right-of-way, land, buildings, plant and general equipment aggregates $114,973,457 (R. I, 20). Adding to this amount 12% thereof to cover the allowance for overheads provided by the Order, the total estimate of reproduction cost new of Chicago physical plant, including overheads, as of December 31, 1922, aggregates $128,770,271. The Commission's finding of reproduction cost new of the same property, including omitted overheads as of December 31, 1922, was $128,769,000 (R. I, 43). The coincidence that the Chicago Company's estimate as of December 31, 1921, is within $1,271 of the Commission's finding as of December 31, 1922, evidently led to the argument by the Chicago Company and to the holding by the Statutory Court that the Commission really intended its estimate to be as of December 31, 1921 (R. I, 195). Under such circumstances, it is argued, the Commission obviously must have overlooked the net additions of $8,292,869 for 1922.

It is, however, just as obvious that two assumptions are necessary before special significance can attach to the coincidence of the approximate same amount in the two estimates, removed in time of application by a year. One necessary assumption is that the price levels of December 31, 1921, continued without decline to December 31, 1922. A decline in price levels of 7½% would more than absorb the net additions for 1922. The second necessary assumption is that the Commission did accept or was legally bound to accept at its face value the Chicago Company's estimate of reproduction cost new as of December 31, 1922, as the sole fact upon which the Commission's finding of reproduction cost new was or could be based. A discount of 7½% from the Company's estimate would more than absorb the amount of net additions for 1922.

The fatal weakness in the argument lies in its necessary assumptions. The assumption by the Chicago Company and by the Statutory Court that the price levels of December 31, 1921, did not decline to December 31, 1922, is contrary to fact. The Chicago Company's Exhibits 44-44F (R. IV, 1426) show the cost trend in the Chicago area of composite plant excluding land and buildings, the cost trend of completed construction of telephone property in Chicago and in Indiana, the construction cost levels of portions of telephone property in the Chicago area, New York City, and Indiana, the labor cost levels in the Chicago area and elsewhere, and the cost levels of central office telephone equipment. All of these exhibits show that there was an abrupt break in price levels between December 31, 1921, and December 31, 1922, which break very easily could have aggregated more than 7½% of the price level as of December 31, 1921; so also, the calculations used on behalf of the Chicago Company to show the estimated reproduction cost new of the Chicago property as of June 30, 1923, show a break of from 5.63% to 8% in price levels in 1922 (R. IV, 1160-1163). The assumption that price levels were constant in 1922 is untrue in fact.

B.

The Statutory Court erroneously assumes that the Commission did or was legally bound to accept at its full face value the Chicago Company's estimate of reproduction cost new of the Chicago physical plant, excluding overheads, as of December 31, 1921, as extended to December 31, 1922, as the sole basis for the Commission's finding of reproduction cost new of the same plant as of the latter date.

The assumption by the Statutory Court that the Commission accepted the estimate made by the Company at

its full face value is pure speculation and has not a single iota of evidence in its support.

There is nothing in the record to show what data the Commission had before it in making its finding. The record before the Commission is not part of the record in the instant case.

Its affirmatively appears from the face of the Commission's Order that (R. I, 15):

> "During the progress of these proceedings exhaustive inquiry was made into matters having to do with the fixing of rates. The transcript of the evidence and arguments approximate 4,500 pages, in addition to which more than 100 exhibits were filed by the company and an approximately equal number by the City of Chicago. During the progress of this case the Commission's accounting staff made an exhaustive investigation and presented voluminous reports as a result thereof."

The Statutory Court's holding necessarily assumes that a discount from the probative force of the Chicago Company's estimate, if in excess of 7½% of the estimate, is so unreasonable as to be void. The Statutory Court assumes, but does not show, that no other evidence bearing on reproduction cost new was contained in the voluminous record before the Commission. Moreover it is significant that the Statutory Court itself discounted the probative force of the same estimate. The Statutory Court found the reproduction cost new of the property as of June 30, 1923. By relating this finding back to December 31, 1922, through the subtraction therefrom of the net additions for the first half of 1923 (there being the same method as was used by the Statutory Court to bring the Commission's estimate of December 31, 1922, forward to June 30, 1923), the Statutory Court's finding of reproduction cost new as of December 31, 1922, was 95.03% of the Chicago Company's estimate of reproduction cost new as of December 31, 1922.

The Statutory Court therefore necessarily holds that a discount in the probative value of the Chicago Company's estimate below 4.97% thereof is so unreasonable as to be arbitrary. If the probative force of the Chicago Company's estimate is as strong as the Statutory Court apparently assumes, ,then it is impossible to reconcile the valuation by the Statutory Court which includes only 85.2% of the Chicago Company's estimate of reproduction cost new. This discount of 14.8% from the face value of the Company's estimate is twice the discount contained in the Commission's finding which the Statutory Court held was void.

C.

The Statutory Court erroneously assumes that the price levels as of December 31, 1922, did not decline to June 30, 1923.

The Statutory Court is wrong also in assuming that with the addition to the Commission's revised estimate and valuations as of December 31, 1922, of the net additions of $9,938,198, to June 30, 1923, the resulting figure will give the Commission's estimate and value as of June 30, 1923. Such assumption is necessarily predicated on the price levels of December 31, 1922, remaining constant to June 30, 1923.

The following considerations show that either the assumption is wrong or the Statutory Court's own calculations are wrong. The Statutory Court accepted the Chicago Company's estimate of reproduction cost new as of June 30, 1923, at its face value in making its own finding of reproduction cost new as of the same date. Therefore the former's estimate of reproduction cost new should logically be $9,938,198 higher than its estimate as of December 31, 1922.

But the difference between the Chicago Company's estimate of reproduction cost new as of December 31, 1922, and as of June 30, 1923, is only $3,488,697. As the aggregate amount of undistributed overheads included in the Company's estimate as of June 30, 1923, was $2,331,277 higher than the aggregate undistributed overheads included in its estimate of December 31, 1922 (R. I, 20; R. IV, 1155), the Chicago Company's estimate as of the later date includes an aggregate increase in physical plant valuation of $1,157,420. If the Statutory Court is sound in assuming that price levels were constant between December 31, 1922, and June 30, 1923, and that the ~~Commission's~~ Company's estimate of reproduction cost new was 100% correct, it follows that the Chicago Company's estimate as of December 31, 1922, was inflated to the extent of $8,780,788 or 12.4% of the book cost of the property as of that date. If the Chicago Company's estimate as of December 31, 1922, is correct, then its estimate as of June 30, 1923, was inflated to the extent of $8,780,788 or 9.2% of the book cost of the property. In this latter case, the findings of the Statutory Court likewise contained an inflated estimate in like amount and in the same per cent of book cost of the property. This discrepancy alone is over $2,500,000 more than the difference between the findings of reproduction cost new by the Commission and by the Statutory Court as of June 30, 1923, and is within $435,000 of the difference between the valuations by the Commission and by the Statutory Court as of June 30, 1923. It is inconceivable that a difference of $435,000 in a total valuation in excess of $120,000,000 will render the Commission's valuations so unreasonable as to be void. Yet such is the necessary conclusion to be drawn from the Statutory Court's holding that the Commission's valuation is void.

Similar inconsistency exists in the Statutory Court's conclusion as to the proper finding of reproduction cost

new which the Commission should have made as of December 31, 1922, and as of June 30, 1923. The Commission's own finding of reproduction cost new as of December 31, 1922, plus the net additions for 1922, which the Statutory Court says were omitted therefrom, is $4,677,778 lower than the Chicago Company's estimate as of the same date for the same property; but the Commission's own finding of reproduction cost new as of December 31, 1922, if extended to June 30, 1923, in the manner specified by the Statutory Court, is $2,000,000 higher than the Chicago Company's estimate of reproduction cost new as of the same date (R. I, 195). On further analysis the anomaly of the situation is even more striking. The Chicago Company and the Statutory Court assume that the Commission's finding contains 12% for overheads. The Chicago Company allowed 17% for omitted overheads as of June 30, 1923 (R. IV, 1155). Deducting the omitted overheads in each case, we find that the Commission's findings of reproduction cost new as of June 30, 1923, held improper by the Statutory Court, would include the sum of $38,126,000, representing an increase to that extent in price levels over book cost of physical property. The Chicago Company's own estimate as of June 30, 1923, on the other hand, included only $28,797,732, representing an increase to that extent in price levels over book cost of physical property. These inconsistencies cannot be reconciled.

D.

The Statutory Court erroneously assumes that the Commission did accept or was legally bound to accept at its full face value the Chicago Company's estimate of reproduction cost new as of June 30, 1923, of the Chicago physical plant, including overheads, as the sole basis for the Commission's finding of reproduction cost new as of that date.

The Statutory Court's finding of the reproduction cost new of the Chicago property as of June 30, 1923, did not separate the amount of omitted overheads from the amount of reproduction cost new of the physical plant. The Statutory Court accepted at its face value the estimate of reproduction cost new by the Chicago Company covering the physical plant and the omitted overheads and held the estimate a reasonably accurate basis for determining a minimum reproduction cost. By so doing the Statutory Court accepted the following irreconcilable discrepancies:

(a) The overhead items included in the Chicago Company's estimate of reproduction cost new as of December 31, 1922, aggregated $18,493,321 (R. I, 20), while its estimate of the same items as of June 30, 1923, aggregated $20,824,598 (R. IV, 1155). Although the Company's estimate of reproduction cost new as of June 30, 1923, showed a net increase of only $1,157,420 in physical plant over its estimate of reproduction cost new of plant as of December 31, 1922, the estimate of undistributed overheads as of the two dates showed between them an increase in the amount of overheads of $2,331,277 or 105% of plant increase. This astounding ratio of increase of undistributed overheads to plant increase is in violent contrast to the estimate by the Company that the undistributed overheads as of December 31, 1922, repre-

sented 15% of the estimated value of the physical plant, and as of June 30, 1923, represented 17% of the estimated value of physical plant as of June 30, 1923. It is obvious that the estimate of undistributed overheads either as of June 30, 1923, or as of December 31, 1922, is inflated to the extent of the greater portion of $2,331,277.*

(b) The overhead item covering engineering was included in the Chicago Company's estimate of reproduction cost new as of December 31, 1922, at $2,936,461. The amount was calculated on the basis of 2.64% of the construction costs, the Chicago Company admitting that the cost of additions as shown on its books include an additional 2.36% for this item (R. I, 21). But the overhead item covering engineering was included in the Chicago Company's estimate of reproduction cost new as of June 30, 1923, at $6,151,819 or on the basis of 5% of the construction costs (R. IV, 1155). As the same witness testified on behalf of the Chicago Company in connection with both estimates, and as the same method was used by him in both estimates of reproduction cost new, it is obvious that if the earlier estimate is correct, the estimate as of June 30, 1923, was inflated to the extent of 47.2%, or $2,903,658.

(c) The Chicago Company included as an overhead item interest during construction as of December 31, 1922, at $10,556,165 (R. I, 20). Although the net additions to plant between that date and June 30, 1923 aggregated $9,938,198, the company included interest during construction as of June 30, 1923, at only $9,604,876 (R. IV, 1155). If the later estimate is correct, as the Statutory Court assumes, the earlier estimate must have been grossly inflated.

Under such circumstances, it was error for the Statutory Court to hold that the Chicago Company's estimate of the

*If it be argued that the per cent of increase of undistributed overheads between the two appraisals should be calculated also on the net additions of 1922, the per cent of increase on such basis is still over 23% as against an average of 15% used for the whole plant in the Chicago earlier estimate and of 17% in its later estimate.

reproduction cost new of the Chicago property furnished a reasonably accurate basis to determine a minimum reproduction cost (R. I, 195). The Statutory Court's valuation which it used as a rate base on which it calculated the minimum per cent return of the net income of the Chicago Exchange should be reduced by $10,214,298.

DEPRECIATION RESERVE.

The amount deducted by the Statutory Court from the otherwise minimum rate base value to cover depreciation was $14,315,372 less than the amount which should have been deducted had it given effect to the Commission's finding on depreciation in valuation.*

The Statutory Court gave effect to the first finding of the Commission by deducting from the rate base value the amount of $26,000,000, representing the net balance of the depreciation reserve account as of December 31, 1922, and gave effect to the second finding by including in its estimated expenses to cover depreciation expenses, $1,835,974 less than the amount which the Chicago Company itself showed as a charge for that item (R. I, 244). The Statutory Court did not find either of the Commission's two findings illegal. But it held that both could not be given effect at the same time, that if one was right the other could not be (R. I, 194). It therefore used two sets of calculations to test the adequacy of the rates complained of (R. I, 197, 198). In one it gave effect to the Commission's finding on depreciation in valuation and to the Chicago Company's depreciation charge as an operating expense. In another, it gave effect to the Commission's findings on depreciation as an operating expense, but deducted from the rate base value for depreciation an amount which was based on the per cent condition of the property, and was $14,315,372 less than the Commission's finding extended to June 30, 1923 (R. I, 248).

*The August 16, 1923 Order of the Commission found that the rate base value should be reduced by the depreciation reserve and fixed an allowance for depreciation as an operating charge.

ERROR OF STATUTORY COURT.

The City contends that the Statutory Court erred in not finding that the amount of the net balance of the depreciation reserve should be deducted from the rate base value (R. I, 226) and in not giving effect in its own determination of the adequacy of the rates complained of to both findings by the Commission on depreciation, because:

I. The use by the Chicago Company of the straight line method of determining depreciation charges involves the principle that it has no right to a return on the amount of property cost, which is represented by the balance in the depreciation reserve.

II. The Chicago Company and the Statutory Court have repudiated the principle upon which the Chicago Company uses the straight line method of determining depreciation charges when they deducted from the rate base value the amount of depreciation reflected by the per cent condition of the property.

III. There was no unfairness in the action of the Commission requiring that the net balance of the depreciation reserve account should be deducted from the rate base value and in prescribing the allowance for annual depreciation charges.

SUMMARY STATEMENT OF CITY'S CONTENTIONS.

In support of contention numbered I, the City offers the following:

(A) The straight line method of determining depreciation charges is based on the theory that the Chicago Company is being reimbursed by each annual depreciation charge for a portion of the total property cost which has been and will be consumed during the period of the service life;

(B) The net balance of the depreciation reserve represents that amount of property cost for the consumption of which the Chicago Company has been reimbursed but which amount has not been written off of the fixed capital account;

(C) The straight line method can be justified only on the theory that the Chicago Company considers itself paid for the amount of property consumption represented by the net balance of the depreciation reserve and will not thereafter be entitled to a return thereon; and

(D) The authorities support the principle that where the straight line method of determining depreciation charges is used, the net balance of the depreciation reserve must be deducted from the rate base value.

In support of contention numbered II, the City offers the following:

(A) The per cent condition of property determined by observation does not reflect the per cent of total property on which the Chicago Company is entitled to receive a return; and

(B) The per cent condition of property as of any given date pending the ultimate property retirement, even if it reflected the operation of all causes of property retirement, cuts off consideration of the balance of the period during which the causes were expected to operate to produce the property consumption reimbursed by the depreciation charges already made and covered by subscribers' rates then in force.

In support of contention numbered III, the City offers the following:

(A) The Statutory Court failed to grasp the essentials of depreciation accounting.

(B) The Statutory Court's holding involves the sanction of the perpetration of a fraud by the Chicago Company on the Commission in procuring the Order of December 20, 1920.

DISCUSSION AS TO CONTENTION NUMBERED I.

I.

THE USE BY THE CHICAGO COMPANY OF THE STRAIGHT LINE METHOD OF DETERMINING DEPRECIATION CHARGES INVOLVES THE PRINCIPLE THAT IT HAS NO RIGHT TO A RETURN ON THE AMOUNT OF PROPERTY COST, WHICH IS REPPRESENTED BY THE BALANCE IN THE DEPPRECIATION RESERVE.

A.

The straight line method of determining depreciation charges is based on the theory that the Chicago Company is being reimbursed by each annual depreciation charge for a portion of the total property cost which has been and will be consumed during the period of the service life.

Through its annual depreciation charges, the Chicago Company provides for reimbursement of the property cost of the property used up in the service during its service life (*Board of Pub. Utility Commissioners* v. *New York Telephone Co.*, 271 U. S. 23, 27; R. II, 890) through causes which may be observed or which must be forecast (R. IV, 1190, 1191). The cost of the property when installed less the salvage value at retirement constitutes the expense of depreciation (R. II, 890). The Chicago Company uses the straight line method of determining depreciation charges (R. V, 1672). By the use of this method it is reimbursed by each installment an equal number of dollars, which amount represents an equal portion of the total depreciation expense of property it has determined will be consumed within the period covered by all the installments. Total consumption of the property during the service life

by all causes whose effect is reasonably ascertainable is the basis and yardstick on which the expense of depreciation is predicated and measured; the installments of reimbursement of that expense therefore represent portions of total property consumption as measured by such yardstick. Whether there has been consumption in fact of the property at any given time within the period equal to the amount of such portion of total property consumption for which reimbursements have been theretofore made, it may be impossible to determine with accuracy and it is not essential to know. (*United Railways and Elect. Co. of Baltimore* v. *West*, 280 U. S. 234, 255.) It is sufficient to know that each installment is reimbursement of a portion of the total property cost which has been and will be consumed in the period of service life. The moneys reimbursed to the Chicago Company belong to it and go into its treasury free from any claims of the users of the property from whose rates the moneys were reserved (R. I, 193). They may be used by the Chicago Company for the purchase of new property upon which a right to a fair return at once accrues from all persons who use the same (*Board of Public Utility Commissioners* v. *New York Telephone Co.*, 271 U. S. 23; R. V, 1673). But this new property merely fills the hole caused by the partial consumption of the original property. In this way, the capital is maintained unimpaired. The detailed demonstration of this fact is shown in Commission's Exhibit 9 (R. I, 231).

B.

The net balance of the depreciation reserve represents that amount of property cost for the consumption of which the Chicago Company has been reimbursed but which amount has not been written off of the fixed capital account.

Because a part of the expense of rendering the service is the cost of property used up in its rendition, such cost must appear in the accounts which show this expense, that is, as part of the operating expenses. Otherwise, the accounts will not reflect the true facts. But it is equally true that because the using up of the property constitutes the expense which is charged, the amount of such property used up must appear in the capital accounts which record the amount of property in use and for which use the Chicago Company is entitled to receive a return. Otherwise the latter accounts will not record the true facts.

These transactions are reflected on the books of the company in two capital accounts and in one expense account. There is added in the fixed capital account the original cost of each unit of plant, but this account is never reduced until a particular unit of plant is actually retired from the service by total consumption. Pending such retirement, no effect is given in this account to any diminution in service value of the unit by reason of its partial consumption in service. Each annual depreciation charge to reimburse the company for such partial consumption is charged to the depreciation expense account and concurrently therewith the same amount is credited to a fixed capital liability account, known as the Reserve for Accrued Depreciation. Concurrently with the reduction in the fixed capital account of the cost of the unit when retired, there is charged to the depreciation reserve account the difference between the

original cost and the net salvage of the property so retired (R. II, 890; R. V, 1672, 1683). The cost of the unit installed in the place of that which was retired is added to the fixed capital account, whether such property cost came from the use of the depreciation funds or from funds supplied by the security holders (*Board of Public Utility Commissioners* v. *New York Telephone Co.*, 271 U. S. 23, 27).

The net balance of the depreciation reserve account represents the depreciation reserve and has a double aspect. In one aspect, it represents in terms of property cost the total amount of property consumption, as previously determined for expense computations by the Chicago Company, which amount has not yet been written out of the capital investment account, but for which amount the company has been reimbursed. In another aspect, it represents the total amount of money reserved from earnings by the depreciation charges and corresponding to the amount of property consumption not yet written off from the capital investment account, which money has gone into the general funds of the company and thence into that property which has taken the place of the consumed property, which has not yet been written off. The two aspects of the net balance of the depreciation reserve account have opposite effects in relation to the fixed capital account in connection with valuation for rate-making purposes. Depreciation in valuation assumes a significance through the first aspect. Having been reimbursed for the property cost of property consumed, the Chicago Company should have no longer any right to a return thereon. The Commission noted, however, only the effect of the second aspect as increasing the amount of the fixed capital by the amount of additions in plant derived from funds reserved from earnings by the depreciation charges. It therefore sought an offset thereto by requiring in its order that no return be allocated on such additions, reasoning that telephone users whose rates sup-

plied the funds which had found their way into this additional plant had some legal claim which gave them exemption from paying any return thereon (R. I, 34).

As the deduction from the fixed capital account of the net balance of the depreciation reserve account gives the same identical result whether one or the other of the aspects of such net balance is given as the reason therefor, the result of the Commission's finding was correct even though its reasoning was not. In fact, on final hearing herein, the Commission itself changed its position and supported the finding on the basis of attaching significance to the first aspect of such net balance figure (R. I, 194). The Statutory Court, on the other hand, pointed out the error of the Commission's reasoning as stated in its order (R. I, 193), but itself failed to give any significance to the first aspect in dealing with depreciation in valuation.

C.

The straight line method can be justified only on the theory that the Chicago Company considers itself paid for the amount of property consumption represented by the net balance of the depreciation reserve and will not thereafter be entitled to a return thereon

The sinking fund method of determining depreciation charges, unlike the straight line method, is based on the theory that the owner of the property is not entitled to reimbursement for property consumption until the *end* of the *service life*, but is entitled to a fair return on all property maintained in condition for proper service regardless of the fact that part of its service life has in fact been consumed. Annual depreciation charges are therefore established on the basis that only sufficient funds shall be reserved therefrom which (if kept continuously invested at compound interest) will together with such interest equal at the

end of the service life the original cost or value of the property consumed at such time (R. V, 1671, 1672). The income from the funds reserved from earnings by the depreciation charges under the sinking fund method (but not under the straight line method) is made available for reimbursement to the owner of the property for the consumption thereof at the date of the retirement of the property. It necessarily follows that the depreciation charges under the former method are lower than those under the latter method. (*United Railways and Electric Co.* v. *West*, 280 U. S. 234, 284, note 55), (R. I, 33, 318). Yet both methods intend to reimburse to the owner of property consumed within a given time the same amount for property consumption. The retention by the Chicago Company of the income on the additional property purchased by funds reserved from earnings by the depreciation charges is justifiable only on the theory that the Chicago Company has established its annual depreciation charges on the basis that to the extent of the amount represented by the net balance of the depreciation reserve at any given time it will consider itself reimbursed or paid for the property consumption and will not thereafter be entitled to a return thereon. There is, therefore, an inseparable connection between the straight line method and the principle that the full net amount represented by the depreciation reserve must be deducted from the rate base value.

D.

The authorities support the principle that where the straight line method of determining depreciation charges is used, the net balance of the depreciation reserve must be deducted from the rate base value.

The Interstate Commerce Commission has permitted the use by the Chicago Company of the straight line method on the basis that the balance of the depreciation reserve

should be deducted from the rate base value. We have introduced as an exhibit (R. I, 259) the Order of the Interstate Commerce Commission entered November 2, 1926, in the proceedings instituted by it under Section 20 (5) of the Transportation Act, directing it to prescribe rates of depreciation, which order covers fully the subject-matter herein discussed. We call attention to the following section of the Order:

> "It is essential to bear in mind, however, that there is an inseparable connection between the straight line method and the principle that accrued depreciation represented by the depreciation reserve must be deducted in ascertaining the rate base value. If any other principle should hereafter be adopted by the courts, a reconsideration of the entire question of depreciation accounting would at once become necessary" (R. I, 320).*

The decisions of This Court imply that the balance of the depreciation reserve should be deducted from the rate base.

The significance of this Court's decision in the recent case of *United Railways & Electric Co.* v. *West,* (280 U. S. 234), on the issue now under discussion is the necessary connection held to exist between the basis of determining depreciation charges and the capital accounts. Depreciation charges are held to reimburse capital consumed (pp. 253, 254). It follows that the utility cannot receive more than one return from the same amount of capital. This double return can be avoided in one of two ways: either it continues to receive a return on the original investment, represented by the capital account, in which case it makes available for reimbursement the income from the additions provided for through the depreciation reserve, or it retains the

*On rehearing, the proposed report of Commissioner Eastman dated August 15, 1929, confirmed the view above expressed, after disposing of the arguments by the Bell System in opposition thereto, made on rehearing. We have reprinted in the Appendix hereto (p. 73) that portion of the document also dealing with the subject-matter herein discussed. This report is referred to in *United Railways and Electric Co.* v. *West*, 280 U. S. 234, Note 57.

latter income and gives up its right to receive a return on the amount of property represented by the net balance of the depreciation reserve account. It cannot claim both.

In *Board of Public Water Commissioners* v. *New York Telephone Co.* (271 U. S. 23, 31), this Court, dealing with a Bell subsidiary which was using the straight line method held that it was entitled to a return on the property purchased from the funds reserved from earnings by the depreciation charges. To avoid unjust enrichment the same utility should not be permitted to deduct from the rate base value less than the net balance of the depreciation reserve.

DISCUSSION AS TO CONTENTION NUMBERED II.

II.

THE CHICAGO COMPANY AND THE STATUTORY COURT HAVE REPUDIATED THE PRINCIPLE UPON WHICH THE CHICAGO COMPANY USES THE STRAIGHT LINE METHOD OF DETERMINING DEPRECIATION CHARGES WHEN THEY DEDUCTED FROM THE RATE BASE VALUE THE AMOUNT OF DEPRECIATION REFLECTED BY THE PER CENT CONDITION OF THE PROPERTY.

A.

The per cent condition of property determined by observation does not reflect the per cent of total property on which the Chicago Company is entitled to receive a return.

The Statutory Court in its calculation which gave effect to the Commission's finding on depreciation as an operating expense deducted from the rate base value the amount of depreciation contended for by the Chicago Company. This

latter amount reflected the 90 per cent condition of the property as found by the Commission and as determined by the employe of the Chicago Company through inspection (R. I, 197), and was $14,315,372 less than the amount of the net balance of the depreciation reserve (R. I, 226). The Commission found "that the property as it now (December 31, 1922), exists is in at least 90 per cent condition." (R. I, 43.) The record before the Commission, not being before the Statutory Court, the basis on which the condition was determined does not appear. From the face of the order itself it appears that "the company's witnesses on valuation of the property stated that the physical condition at the present time is about 92 per cent of its condition new" (R. I, 27). The previous order of the Commission made December 20, 1920, stated that its valuations "do not take into consideration the present condition of the property and the percentages fixed by the engineers for the petitioner and the City of Chicago do not provide any allowance for inadequacy and obsolescence existing in the property * * *. The Engineers for petitioner and the City of Chicago agree that the present service value of the property is at least 90 per cent" (R. IV, 1290). If any deduction can be drawn from the face of these orders covering the condition of the property at different dates only three years apart, it is that the condition of the property referred to in both orders has the same meaning and that in both the per cent condition excludes consideration of those causes of retirement whose effect must be forecast rather than observed. The term "per cent condition" as used by the Chicago Company's one witness on valuation on final hearing herein was defined by him as the "condition as determined by the evidence of rust, decay, wear or action of the elements which deteriorate a piece of property. I do not mean the per cent of its remaining life when I use the term 'per cent con-

dition'" (R. II, 702). His opinion on "condition" was made as a result of his own inspection of the property (R. II, 700). He inspected 300 telephone stations in service out of a total of 657,000 (R, II, 708); 20 manholes to determine the condition of underground conduit and underground cable having a book value of over $28,000,000 (R. II, 706; R. IV, 1157) and similar insignificant portions of total plant items in service (R. II, 701, 708). It should be borne in mind also that since 1911 no physical inventory has been taken of the Chicago property, the company's valuations being based on the application of index numbers to book cost of plant (R. I, 195). It did not, therefore, have the benefit normally resulting from observation made in taking inventory.

The result of the inspection by this one witness is the only evidence in the record to support the per cent condition of the property which was reflected in the contention by the Chicago Company on depreciation in valuation and which contention the Statutory Court said it followed (R. I, 197). We submit that the meager evidence submitted by the Chicago Company at most covered only those causes of retirement which are observable by inspection. Depreciation in valuation which reflects the per cent condition excludes from consideration obsolescence and inadequacy resulting from age, changes in the art, public requirements * * * casualties, changes in public demand, and losses through destruction of property by extraordinary casualties (R. IV, 1191; *Chesapeake & Potomac Tel. Co.* v. *Whitman*, 3 Fed. (2d) 938, 943).

B.

The percent condition of property as of any given date pending the ultimate property retirement, even if it reflected the operation of all causes of property retirement, cuts off consideration of the balance of the period during which the causes were expected to operate to produce the property consumption reimbursed by the depreciation charges already made and covered by subscribers' rates then in force.

By viewing the property consumption as of the date of valuation, the Chicago Company assumes that all of the consumption for which it has been reimbursed up to that date occurred prior to the date of valuation. In establishing the annual charges, however, from which the reimbursements to that date were accumulated, the Chicago Company established the period of consumption as the total service life of the property and apportioned the total consumption over the entire period in equal average instalments. These instalments, as already noted, need not correspond to the actual consumption which in fact took place at the date of valuation. The conclusion by the Chicago Company that the consumption which in fact took place up to the date of valuation corresponds exactly to the average consumption based upon the percentage of total consumption, is a guess.

Two of the essentials of the straight line method are: (1) the causes of property consumption are all causes whether observable through inspection as wear and tear, or subject to forecast as obsolescence and inadequacy caused by improvements in the art, public requirements, storms, and other casualties of similar nature, and (2) the period during which the causes are to operate which result in property consumption is the full period of the service life.

The annual depreciation charges represent equal contributions to the total cost of property consumption. The determined average property consumption covered by each installment may not and need not correspond to the actual consumption which has taken place at any given time within the period.

A repudiation of the basis on which this charge is established will result if the scope of the causes of retirement is narrowed in determining depreciation in valuation, and/or if the period during which the causes of retirement are expected to operate to produce the property consumption covered by the depreciation in valuation is limited to the period ending at the date of valuation.

The depreciated rate base value found by the Statutory Court constitutes such a repudiation. The accumulated depreciation charges as of June 30, 1923, showed that reimbursement of $27,404,372 had already been made to the Chicago Company to that extent for property consumption measured by property cost, which had already taken place or which it had determined would take place pending the ultimate retirement of the property. The Statutory Court reflects in the rate base value reimbursement of only $13,089,000 for property consumption (R. I, 197, *supra*, 316). Its required minimum per cent return was calculated on a rate base value which was excessive by $14,315,372.

DISCUSSION AS TO CONTENTION NUMBERED III.

III.

THERE WAS NO UNFAIRNESS IN THE ACTION OF THE COMMISSION REQUIRING THAT THE NET BALANCE OF THE DEPRECIATION RESERVE ACCOUNT SHOULD BE DEDUCTED FROM THE RATE BASE VALUE AND IN PRESCRIBING THE ALLOWANCE FOR ANNUAL DEPRECIATION CHARGES.

A.

The Statutory Court failed to grasp the essentials of depreciation accounting.

The Statutory Court held that the Commission can make either finding but not both. The Statutory Court gave effect to one finding in each of its own calculations. The Statutory Court's holding is clearly the result of its failure to grasp the essentials of the straight line method of determining depreciation charges. This is clear from the following consideration:

The Chicago Company cannot be compelled to use any part of the reimbursements reserved at any given date from earnings by depreciation charges covered by rates already charged to provide the reimbursements to which it is legally entitled to have included in the annual charge to be covered by rates in force thereafter (*Board of Public Utility Commissioners* v. *New York Telephone Co.*, 271 U. S. 23). The Chicago Company cannot make the rates in force after a given date cover annual depreciation charges which include reimbursements for property cost of property consumption for which the Chicago Company has already been reimbursed (*supra*, 323). But the Chicago Company can make the rates in force after a given date cover annual

depreciation charges which include annual contributions of reimbursement for the balance not yet reimbursed of the net expense of property retirement of property installed prior thereto, even though such contributions may be larger than those made to accumulate the reimbursements already made.* . The Commission having the power to prescribe depreciation rates, can make the rates in force after a given date cover annual depreciation charges which include annual contributions of reimbursement for the balance not yet reimbursed of the net expense of property retirement of property installed prior thereto, even though such contributions may be smaller than those made to accumulate the reimbursements already made.

To deny the power in the Commission to determine at any given time how much the balance is of the net expense of property retirement on property installed prior thereto, to which balance the Chicago Company is thereafter entitled to be reimbursed, and to determine how to spread that balance over the years of the life of property, is to deny its power to prescribe depreciation rates conferred by statute (R. I, 76).

The Statutory Court, conceding the power of the Commission to deal with past accumulations in their proper relation to valuation as a basis for future rate-making, or with the future accumulations in their proper relation to operating expenses as a basis for future rate-making, de-

*The depreciation rates used by the Chicago Company from 1912 to 1928 are shown in Commission's Exhibit 15 (R. I, 240). The statement showing ~~valuations~~ variations in the service life of different classes of telephone property is shown in Commission's Exhibit 14 (R. I, 239). The composite rates compiled therefrom are as follows:

Jan. 1, 1913—Dec. 31, 1917	5.75%
Jan. 1, 1919—July 31, 1918	5. %
Aug. 1, 1918—July 31, 1919 (Gov't control period)	5.72%
Aug. 1, 1919—Dec. 31, 1920	5. %
Jan. 1, 1921—Dec. 31, 1923	4.63%
Jan. 1, 1924—Dec. 31, 1927	4.67% (a)
Jan. 1, 1928—	4.87%

For the year 1924 the composite rate was 4.595, and for 1925 the rate was 4.694 (R. II, 889).

nies the fairness of the exercise by it of both powers in connection with the same rate-making process. The Statutory Court simply failed to grasp the function of depreciation accounting.

The Commission used the experience of the past as evidence of what the probable future requirements might be. In the light of that experience, plus all other evidence in the record (some of the details of which are given in its order (R. I, 29), the Commission established the charge which it considered a proper current charge for depreciation. It did not commit the error committed by the New Jersey Commission, as disclosed in the case of *Board of Public Utility Commissioners* v. *New York Telephone Co.*, 271 U. S. 23. In that case the Commission attempted to cut down the net balance of the depreciation reserve accumulated from past annual charges because it considered such net balance excessive. It sought to accomplish this purpose by allowing to the utility, as a current depreciation expense, a sum less than that which the Commission found would have otherwise been allowed as a reasonable allowance (*Idem.*, 30, 32).

B.

The Statutory Court's holding involves the sanction of the perpetration of a fraud by the Chicago Company on the Commission in procuring the Order of December 20, 1920.

The experience of the Chicago Company under the Order of December 20, 1920, is instructive. It sought and received an increase in rates under that order, which rates were in force in 1923 under the temporary injunction and still are in force (R. I, 178). These rates were based upon the proposal by the Chicago Company which was accepted by the Commission, that the full net balance of the depreciation reserve account in the amount of $16,274,604 should be de-

ducted from the rate base value for depreciation instead of the amount of $7,821,720, which would reflect the per cent condition of the property (R. IV, 1294). The difference between the two items is $8,442,904. The Commission by that same order made an annual allowance for depreciation as an operating expense (R. IV, 1300). The Chicago Company has never complied with this latter finding from the effective date of the order (R. II, 894), though it has never appealed from the order itself, though it has continued to function under the rates prescribed by it, (R. I, 189), and though it has claimed the reasonableness of these rates in its answer to the citation in the proceedings leading up to the order of August 16, 1923 (R. I, 13). The Chicago Company included in its showing of operating expenses a depreciation charge for 1923 which was $1,636,556 in excess of the amount allowable under the order of December 20, 1920 (R. I, 188, 229, 420). The Statutory Court accepted the Chicago Company's showing in the calculation in which it deducted the net balance of the depreciation reserve from the rate base value to cover depreciation in valuation (R. I, 197).

Based upon the per cent condition which the Statutory Court found applicable to the Chicago operations, the benefit to the public through a reduced amount of required return because of the consent by the Chicago Company to the deduction of the reserve did not exceed $500,000 (6% on $8,442,904). The loss to the public by the disregard of the Chicago Company of the findings in the order on depreciation as an operating expense was $1,636,556, making a net loss to the public of $1,136,556 to be absorbed in the rates which the Statutory Court holds confiscatory. The result of the Statutory Court's holding, therefore, is that the Chicago Company profited $1,136,556 by disregarding the order of December 20, 1920, and was justified in so doing because

the Chicago Company consented to the deduction of the depreciation reserve which in turn gave the Chicago Company the right to disregard the finding on depreciation as an operating expense. But the Order of December 20, 1920, recites that the Chicago Company's proposition was intended to benefit the public (R. IV, 1289). On the basis of the Statutory Court's holding, the Chicago Company's proposition to the Commission on the basis of which that order was issued was a fraud.

That the exercise by the two Commissions of their powers to deal with depreciation as an operating expense and with depreciation in valuation was not unfair and did not commit the error condemned by this Court in *Board of Public Utility Commissioners* v. *New York Telephone Co.* (271 U. S. 23), is conclusively shown by the following tables. These tables show that both Commissions not only allowed sufficient amounts to meet the Company's actual depreciation requirements, but also allowed substantial sums over and above the actual needs to accumulate in the Depreciation Reserve.

COMPARISON OF THE FINDINGS FOR DEPRECIATION IN THE ORDER OF PUBLIC UTILITIES COMMISSION OF 12/20/20 WITH THE CHICAGO COMPANY'S CHARGES.

	Commission's Allowance for Depreciation	Chicago Company's Charges	Excess of Company's Charges over Allowance	Realized Depreciation for Property Retired	Percentage of Plant Retired to Commission's Allowance and Company's Charges		Amount Available from Commission's Allowance for Increase of Depreciation Reserve
					Commission Allowance	Company Charges	
1921	$ 2,103,332	$ 3,369,849	$1,266,517	$ 611,572	29.08%	18.15%	$1,491,760
1922	2,350,999	3,739,869	1,388,870	894,084	38.03%	23.91%	1,456,915
1923	2,844,398	4,480,954	1,636,556	1,509,877	53.08%	33.70%	1,334,521
1924	3,311,624	4,709,950	1,398,326	2,151,611	64.97%	45.68%	1,160,013
1925	3,806,927	5,385,712	1,578,785	1,932,472	50.76%	35.88%	1,874,455
	$14,417,280	$21,686,334	$7,269,054	$7,099,616			$7,317,664

COMPARISON OF THE FINDINGS IN THE ORDER OF 8/16/23 ON MAINTENANCE AND DEPRECIATION WITH THE CHICAGO COMPANY'S CHARGES.

	Allowance for Maintenance and Depreciation	Chicago Company's Charges	Excess of Company's Charges over Allowances	Actual Charges for Maintenance and Losses of Property Retired	Amount Available from Commission's Allowance for Increase of Depreciation Reserve
1922	$ 7,456,630	$ 8,829,575	$1,372,945	$5,983,789	$1,472,840
1923	8,546,713	10,382,687	1,835,974	7,407,893	1,155,103
1924	9,550,138	11,036,281	1,486,143	8,477,942	1,072,196
1925	10,610,290	12,262,300	1,652,010	8,795,924	1,814,366
			$6,347,072		$5,514,505

The Statutory Court erred in not deducting the full balance of the depreciation reserve in its calculations in which it gave effect to the Commission's finding on depreciation as an operating expense.

DEPRECIATION EXPENSE.

The operating charge set up by the Chicago Company to cover the expense of depreciation for 1923 was $1,835,974 in excess of the allowance prescribed by the Order of August 16, 1923 (R. I, 194, 244), **which Order it has attacked as confiscatory. This operating charge was also $1,636,556 in excess of the allowance prescribed by the Order of December 20, 1920** (R. I, 251; R. IV, 1300), **which Order prescribed the rates in force in 1923 under the temporary injunction issued in the instant case and still in force** (R. I, 189). **The Chicago Company has never appealed from the Order of December 20, 1920.**

Before the Statutory Court the propriety of the action by the Chicago Company in disregarding the two orders as to depreciation charges, was in issue. The Statutory Court refused to approve or to disapprove such disregard by the Chicago Company,* on the ground that even if depreciation expense were charged in conformity with the allowance prescribed by the Order of August 16, 1923, the net return calculated on the proper basis would still be inadequate (R. I, 197, 8). No mention was made by the Statutory Court of the binding effect of the finding contained in the Order of December 20, 1920, which finding has never been followed by the Chicago Company (R. II, 894). The Chicago Company did not take an appeal from nor did it assign error to the Statutory Court's findings or to its final decree entered herein.

*The Statutory Court used $1,800,000 as a round number figure (R. I, 197, 8).

The maximum difference between a constitutionally adequate and an inadequate net income in the instant case is not over $1,700,000 (*infra,* 346). Therefore the propriety or impropriety of including as an operating charge $1,835,794 in excess of the allowance for depreciation prescribed by the Order of August 16, 1923, or of including as an operating charge $1,636,556 in excess of the Order of December 20, 1920, becomes an issue of controlling importance.

SUMMARY STATEMENT OF CITY'S CONTENTIONS.

The City contends:

I. Not having appealed or assigned error to the failure by the Statutory Court to pass on the propriety or impropriety of the Commission's finding of fact covering the allowance for depreciation, the Chicago Company is foreclosed from attacking such finding before this Court.

II. If the finding of the Order of August 16, 1923, covering the allowance for depreciation is void, then only the allowance prescribed by the Order of December 20, 1920, can be legally included as an operating charge.

DISCUSSSION AS TO CONTENTION NUMBERED I.

I.

NOT HAVING APPEALED OR ASSIGNED ERROR TO THE FAILURE BY THE STATUTORY COURT TO PASS ON THE PROPRIETY OR IMPROPRIETY OF THE COMMISSION'S FINDING OF FACT COVERING THE ALLOWANCE FOR DEPRECIATION, THE CHICAGO COMPANY IS FORECLOSED FROM ATTACKING SUCH FINDING BEFORE THIS COURT.

Depreciation is a fact and the Commission's allowance for depreciation is a finding of fact (*Georgia Ry. & P. Co.* v.

Railroad Com. 262 U. S. 625, 633). The finding is presumptively valid (*Banton* v. *Belt Ry.*, 268 U. S. 413, 422). The Statutory Court expressly refused to pass on the issue of the propriety of such finding (R. I, 198). The Chicago Company is foreclosed from attacking before this Court exercising an appellate jurisdiction the Commission's finding of fact. The City did assign error to the failure by the Statutory Court to find that the Chicago Company violated the Order of August 16, 1923, and of December 20, 1920, in setting up its charges for depreciation (Assignments of Errors, 24, 40, 56; R. I, 206, 208, 210). Until, however, the Chicago Company can show that this Court should disregard the binding effect of these orders for the purpose of determining the net return from the Chicago operations in considering the legal adequacy of the rates prescribed by the Order of August 16, 1923, this Court should not be burdened with any argument by the City on its assignments of error relating thereto.

DISCUSSION AS TO CONTENTION NUMBERED II.

II.

IF THE FINDING OF THE ORDER OF AUGUST 16, 1923, COVERING THE ALLOWANCE FOR DEPRECIATION IS VOID, THEN ONLY THE ALLOWANCE PRESCRIBED BY THE ORDER OF DECEMBER 20, 1920, CAN BE LEGALLY INCLUDED AS AN OPERATING CHARGE.

The Commission's allowance for depreciation, as prescribed in the Order of December 20, 1920, was a finding of fact (R. IV, 1299, 1300). This finding of fact was made a case in which the Chicago Company itself asked for an increase in rates. The increase was granted (R. IV, 1307, 1308). The Chicago Company has not only put in force the

rates prescribed by the Order of December 20, 1920, without appealing therefrom, but for almost 10 years has taken no step to have the order modified (R. I, 189). The Chicago Company has asked the Statutory Court to exercise its extraordinary discretionary powers to relieve the Chicago Company of the effects of the order of August 16, 1923, so that the order of December 20, 1920, might continue to determine the rates under which it should function. The Statutory Court has granted that relief.

The Chicago Company is before this Court in support of the action by the Statutory Court. At the same time, the Chicago Company, not having brought up to this Court the issue, seeks affirmative relief from this Court against a portion of the very order under which it will continue to operate if the Statutory Court is sustained. This Court has affirmed the refusal by a Statutory Court to relieve a petitioner from the effects of a commission's order which it had sought where the attack thereon is that the order is void because the statute under which the Commission was acting was unconstitutional (*United Fuel Gas Co.* v. *Railroad Commission of Kentucky,* 278 U. S. 300). In the instant case, the Chicago Company seeks affirmative relief against a portion of an order which it otherwise contends is valid. It seeks the relief from an appellate tribunal in a collateral proceeding without having brought before such tribunal from the tribunal of original jurisdiction the issue of the validity of that portion of the order complained of. The relief should not be granted.

PART III.

RATE OF RETURN.

The net earnings for 1923-1925 found available by the Statutory Court for return, after making the reduction of the rates prescribed by the Order of August 16, 1923, were adequate on the basis of any one of four separate tests.

The Statutory Court found that the net earnings for 1923, after making the $1,700,000 reduction under the rates established by the Order of August 16, 1923, were $6,740,000, yielding a net return of 5.39% (R. I, 197), which per cent return was constitutionally inadequate on the authority of *McCardle* v. *Indianapolis Water Co.*, 272 U. S. 400, 419, and in the cases cited therein in Note 4 and of *United Railways & Electric Co.* v. *West,* (280 U. S. 234). It further held that its finding of confiscation for 1923 applies with increasing force to the succeeding years(R. I, 198).

SUMMARY STATEMENT OF CITY'S CONTENTIONS.

The Statutory Court erred because:

Test I.

The actual experience of the Chicago Company for a period of five years since the effective date of the Order complained of proves the error of the holding that the amount found by the Statutory Court available for return after making the reductions under the rates prescribed by that Order, was less than a minimum to which the Chicago Company was constitutionally entitled.

In support of this test the City submits the following:

A. The net earnings from the Chicago operations for the years 1923, 1924 and 1925, as found by the Statutory

Court after giving effect to the reduction under the rates prescribed by the Order of August 16, 1923, exceeded the net earnings which the Chicago Company showed that it was receiving from its Chicago operations and from its entire operations during each of these years before making such reduction.

B. The Chicago Company has attracted capital during the years 1923-1925 on a most favorable basis and has maintained the stability of its securities in comparison with those of other high grade utilities.

Test II.

After adjusting the rate base value for 1923, as found by the Statutory Court, to give effect to the Commission's finding on rate base value and/or on depreciation in valuation, the net earnings available for return in 1923, as found by the Statutory Court, are clearly adequate.

Test III.

The net earnings available for return in 1923, as found by the Statutory Court, are clearly adequate after taking into account the excessive payments made by the Chicago Company to the American Company and the many costly services rendered by the Chicago Company to the American Company free of charge.

Test IV.

The net earnings available for return in 1923, as found by the Statutory Court, are more than the minimum which the Chicago Company is constitutionally entitled to receive therefrom, when tested on a comparable basis by the yardstick properly applicable to determine the required minimum net earnings from the operations of the Bell licensee companies.

In support of this test, the City contends that the application by the Statutory Court in the instant case of the yardstick applicable to determine the minimum return to which an independent enterprise is constitutionally entitled, was error because:

I. It failed to take into account and to give effect to the fact that the Chicago Company, as part of the Bell System, differs so widely in form of organization and in relation to the public and the investors from the enterprises considered in the cases cited by the Statutory Court that their experience is rendered wholly inapplicable to it.

II. The net earnings available for returns in 1923, as found by the Statutory Court, are legally adequate, as tested by the yardstick applicable to and in fact used in the Bell System in 1923 to determine the adequate returns to each licensee company from its own operations.

In support of its contention numbered I under test numbered IV, the City offers the following:

A. The actual experience of the Chicago Company for five years after the effective date of the Order complained of demonstrates the futility of applying to it the experience of independent enterprises.

B. The Chicago Company, as part of the Bell System, admittedly occupies a unique position in the form of its organization and in relation to the public and investors.

C. The elements of its uniqueness are:

(1) The American Company has destroyed the possibility of operating the Chicago Company as an independent enterprise.

(2) The American Company has destroyed the possibility of determining the actual costs and charges of the services of the Chicago Company from the latter's records alone.

(3) Part of the earnings available for return on the investment of the Chicago Company is held in the treasury of the American Company, the record of the amount of which, and the use whereof, are not available to the Chicago Company as an independent enterprise.

(4) The American Company had destroyed the going value of the Chicago Company as an independent enterprise.

In support of its contention numbered II the City offers the following:

A. The American Company has made itself the financing company to provide the permanent capital for the licensee companies of the Bell System.

B. The American Company, as the financing company, has provided a cooperative plan for the financing of the licensee companies.

C. The required net earnings from the operations of each licensee company are admittedly less than the minimum per cent return necessary to attract capital or to maintain the stability of its securities under the cooperative plan of financing the licensee companies of the Bell System.

D. There is no possible basis of comparison between the required minimum net earnings from the operations of licensee companies and those of independent enterprises to which they might be expected to be similar.

E. There is no possible basis on which the yardstick applied in cases of independent enterprises to determine the minimum net return to which a utility is constitutionally entitled can be applied to determine the minimum net earnings from its own operations to which a Bell licensee company is constitutionally entitled.

F. To determine the minimum return to which the Chicago Company is constitutionally entitled in relation to the

net earnings from its own operations in Chicago, the only possible yardstick applicable thereto is the average per cent return, on a comparable basis, on the investment of the Bell licensee companies as a whole, as used in fact or as found necessary to finance their needs and to maintain the stability of their securities.

G. The net earnings available for return in 1923 are more than the minimum which the Chicago Company is constitutionally entitled to receive therefrom, when tested, on a comparable basis, by the yardstick properly applicable to determine the required minimum net earnings from the operations of the Bell licensee companies.

DISCUSSION AS TO TEST NUMBERED I.

I.

THE ACTUAL EXPERIENCE OF THE CHICAGO COMPANY FOR A PERIOD OF FIVE YEARS SINCE THE EFFECTIVE DATE OF THE ORDER COMPLAINED OF PROVES THE ERROR OF THE HOLDING THAT THE AMOUNT FOUND BY THE STATUTORY COURT AVAILABLE FOR RETURN AFTER MAKING THE REDUCTIONS UNDER THE RATES PRESCRIBED BY THAT ORDER, WAS LESS THAN A MINIMUM TO WHICH THE CHICAGO COMPANY WAS CONSTITUTIONALLY ENTITELD

A.

The net earnings from the Chicago operations for the years 1923, 1924 and 1925, as found by the Statutory Court after giving effect to the reduction under the rates prescribed by the Order of August 16, 1923, exceeded the net earnings which the Chicago Company showed that it was receiving from its Chicago operations and from its entire operations during each of these years before making such reduction.

The net earnings of $6,740,000 found by the Statutory Court available for return in 1923, after making the reduction of $1,700,000 under the rates prescribed in the Order of August 16, 1923 (attacked as confiscatory), were $460,000 more than the net earnings which the Chicago Company showed as available for return from the same operations under the rates established by the previous Order and then in force, before making the $1,700,000 reduction (R. IV,

1193).* Similarly the net earnings found available by the Statutory Court for the years 1924 and 1925, after making the reduction in each year under the rates established by the Order of August 16, 1923, were $125,470 and $273,750** in excess of the earnings shown by the Chicago Company as available from the same operations in the same years under the rates then in force, but *before* giving effect to the reduction for these years under the rates prescribed by the Order of August 16, 1923 (R. IV, 1193). Therefore, the net earnings which the Statutory Court held confiscatory exceeded those which the Chicago Company claimed it was in fact receiving from the Chicago operations during those years under the rates then in force.

The Chicago Company has never taken any steps to have increased the rates prescribed by the Order of December 20, 1920, although under the Public Utilities Act of Illinois it had the right so to do at any time after two years from the effective date of such Order or at any time after January 1, 1923 (Section 67, R. I. 114). Yet the Chicago Company showed that the amount available for return from these rates when related to book cost of physical property in Chicago was—in 1923, 6.22%; in 1924, 6.26%; and in 1925, 5.79%—a yearly average return of 6.08% (R. IV, 1193). This showing compares with a per cent return on the same basis yielded by the net earnings found available by the Statutory Court of 6.67% for 1923; 6.37% in 1924; and 6% in 1925—a yearly average return of 6.32%. Using

*The Statutory Court added to the Company's showing $360,000, representing the excess charge to operating expenses of the license payment over that allowed under the Order of August 16, 1923, and also added back $1,800,000, representing the excess depreciation charged to operating expense by the Chicago Company in excess of that held allowable by the Commission. The Statutory Court then deducted $1,700,000 to give effect to the reduction prescribed by the Order of August 16, 1923, leaving a net gain to income in the amount available of $460,000 (R. I, 197).

**The Chicago Company's showing of income available for return during the years 1924 and 1925 (R. IV, 1193) was adjusted in each case to reflect the Commission's findings to cover the proper license payments, maintenance and depreciation charges, and the reduction in subscribers' rates (R. I, 244).

as a rate base the original book cost of the physical property of the Chicago Company as a whole, we find that for the three-year period, 1923-1925, inclusive, the entire net income of the Chicago Company from all sources available for return thereon was—in 1923, 6.23%; in 1924, 6.17%; and in 1925, 6.10%—a yearly average of 6.16% (R. VI, 2120, 2121). This showing was before making the reductions under the rates prescribed by the Order of August 16, 1923. The Statutory Court's finding of net earnings from the Chicago operations, *after* making reductions, was, in each year, more favorable than the showing of the company as a whole *before* making the reductions.

B.

The Chicago Company has attracted capital during the years 1923-1925 on a most favorable basis and has maintained the stability of its securities in comparison with those of other high grade utilities.

As the Statutory Court's finding of net earnings was in each of the three years in excess of the showing for the Chicago Company as a whole, we would certainly expect that the rate of return under which the Chicago Company has operated would be wholly inadequate to attract new capital, and to maintain the stability of its issued securities in comparison with those of similar ventures. The record disproves any such condition. The Chicago Company issued $50,000,000 bonds in 1923 at a cost to it of 5.53% (R. V, 1610, 1611); the American Company issued $100,000,000 bonds in the same year at a cost to it of 6.07% (R. VI, 2302; R. IV, 1277). The bonds of the Chicago Company issued in 1923 were sold to the public on a yield of 5.30%; those of the American Company on a yield of 5.63% (R. IV, 1276, 1277). From the date of issue to the end of 1927, the yield to the holder of the bonds of the Chicago

Company was in each year lower than the yield on the American Company bonds issued in 1923 (R. VI, 2160). In 1923 the Commonwealth Edison Company of Chicago also issued $50,000,000 bonds. These sold from the date of issue to the end of 1925 on a higher yield to the investor than the yield on the Chicago Company's bonds, but on a lower yield than the American Company's bonds issued in 1923 (R. VI, 2160). But the stock of the Commonwealth Edison Company sold on a lower yield than that of the American Company.

The stock of the American Company in the hands of the public in 1923 sold on a yield ranging from 6.99% to 7.56%; in 1924 on a yield from 6.86% to 7.43%; and in 1925 on a yield from 6.21% to 6.89% (R. VI, 2160). The stock of the Commonwealth Edison Company in the hands of the public sold on a yield of 6.10% to 6.35% in 1923; 5.82% to 6.34% in 1924; and 5.64% to 6.13% in 1925 (R. VI, 2160).

The bonds of the Chicago Company issued in 1923 were sold in the open market on a lower yield, with two exceptions, than any of the thirty-six issues of public utility bonds of $5,000,000 or over sold in that year (R. IV, 1276), and on a lower yield than the average yield in 1923 from fifteen high grade public utility bonds (R. I, 254). From the date of issue to the end of 1927, the yield to the holder of these bonds of the Chicago Company was in each year lower than in the previous year (R. VI, 2160), and was in each year as low or lower than the average bond yield on fifteen high grade public utility bonds (R. I, 254). This record is all the more significant in view of the fact that beginning with 1925 the showing of the Chicago Company from its Chicago operations under the rates prescribed by the Order of December 20, 1920, which it did not seek to have increased, represented a lower yield than that of the previous year and was from 1% to 1¾% lower than the yield which the Statutory Court found was confiscatory (R. IV, 1194).

During the years 1923, 1924 and 1925, the Chicago Company issued and sold at par $20,000,000 par amount of stock, and during the succeeding three years sold an additional $30,000,000 par amount of stock (R. VI, 2160; R. V, 1833-4), of which the American Company purchased at least 98.75%, of $49,375,000 (R. VI, 1982); 8% dividends were paid on all of its outstanding stock (R. V, 1860). It is inconceivable that the American Company, as the investor in the Chicago Company, would have permitted the Chicago Company to continue to operate under the rates prescribed by the Order of December 20, 1920, had the earnings thereunder been below that which the ordinary investor would have required to be attracted to invest in a utility of the character of the Chicago Company.

DISCUSSION AS TO TEST NUMBERED II.

II.

AFTER ADJUSTING THE RATE BASE VALUE FOR 1923, AS FOUND BY THE STATUTORY COURT, TO GIVE EFFECT TO THE COMMISSION'S FINDING ON RATE BASE VALUE AND/OR ON DEPRECIATION IN VALUATION, THE NET EARNINGS AVAILABLE FOR RETURN IN 1923, AS FOUND BY THE STATUTORY COURT, ARE CLEARLY ADEQUATE.

The Statutory Court's rate base value was $10,214,298 more than the valuation found by the Commission as the rate base (*supra,* 300). The Statutory Court deducted from the rate base value for depreciation $14,315,372 less than the amount which the Commission held should be deducted (*supra,* 316). The per cent return of the net earnings found by the Statutory Court available for return in 1923, if calculated on the Statutory Court's valuation after making the adjustment to give effect only to the Commis-

sion's finding on rate base value, will be 5.87%; if calculated on the Statutory Court's valuation after making the two adjustments to give effect to the Commission's findings on rate base value and on depreciation in value, will be 6.71%.

Such per cent return adds from .48% to 1.32% to the per cent return as found by the Statutory Court; the latter finding in turn being more favorable than the showing both of the Chicago Company as a whole and of its Chicago operations on which the Chicago Company financed itself (*supra*, 346). Therefore, the adjusted per cent return is clearly adequate.

DISCUSSION AS TO TEST NUMBERED III.

III.

THE NET EARNINGS AVAILABLE FOR RETURN IN 1923, AS FOUND BY THE STATUTORY COURT, ARE CLEARLY ADEQUATE AFTER TAKING INTO ACCOUNT THE EXCESSIVE PAYMENTS MADE BY THE CHICAGO COMPANY TO THE AMERICAN COMPANY AND THE MANY COSTLY SERVICES RENDERED BY THE CHICAGO COMPANY TO THE AMERICAN COMPANY FREE OF CHARGE.

The net earnings of $6,740,000 available for return in 1923, as found by the Statutory Court, are the balance of total net earnings from the Chicago operations after their absorption of the following items of expense paid to the American Company incurred by the Chicago Company for the benefit of the American Company without reimbursement or compensation:

A. The cost to the Chicago Company of the use by the American Company in its long distance service of the Chi-

cago local exchange plant represented in 1923 by $57,000,000 book cost of plant and of items of expense incurred in its operations aggregating $18,000,000 (*supra*, 35).

B. The difference between the cost of use in the long distance service of the balance of the Chicago facilities and the distribution made to the Chicago Company therefrom (*supra*, 117).

C. The sum of $655,000 representing the balance of the excessive payment* included in the 4½% license payment made to the American Company in 1923 or in the alternative, the cost to the Chicago Company and/or the benefit to the American Company of the following:

(1) The sum of $120,000 improperly included in the charge for rental of telephone instruments.

(2) The eight special financial services rendered by the Chicago Company, without charge, to the American Company in 1923:

(a) The use, free of charge, of the entire operating local organization of the Chicago Company, as the local selling agency for the sale of the American Company's stock to the public, and the use of the Chicago Company's facilities and of its accessibility to more than 600,000 local exchange customers for such stock selling operations in 1923;

(b) The use, free of charge, of the facilities of the Chicago Company in selling the American Company's stock to the employees of the former, and in collecting and remitting installment payments aggregating $1,500,000 in 1923;

(c) The profit to the American Company through filing consolidated income tax returns and charging the Chicago Company on the basis of a separate return;

(d) The payment to the Central Union (and through it to the American Company, the owner of 99% of its stock) of a profit of at least $3,700,000 included in the purchase price for the Central Union properties transferred to the Chicago Company, which

*The Statutory Court allowed as an operating charge for 1923 a license payment of $1,364,000 (R. I, 191). The City contends that only $709,000 should be charged (*supra*, 217).

properties had been operated at a loss for at least seven years prior thereto;

(e) The profit to the American Company derived through the method of financing the Chicago Company by investing therein only in stock yielding 8%, as compared to the method of financing the balance of the Bell System on the basis of investing therein partly in stock yielding 8% and partly in credit obligations yielding 5.88%.

(f) The use of the credit of the Chicago Company to finance thereafter the Central Union properties conveyed to it, in lieu of the use of the credit of the American Company which theretofore for many years had been the sole credit used for that purpose;

(g) The use of the Chicago Company's credit to permit the American Company to withdraw in cash more than the entire amount of its capital investment in the Central Union properties transferred to the Chicago Company, which capital investment prior thereto had been wiped out through losses in operation, and at the same time to permit the American Company to retain the same interest in the future earnings of such properties;

(h) The use of the credit of the Chicago Company to liquidate $13,800,000 long past due indebtedness owing from the Central Union to the American Company;

(3) The profit to the Western Electric (and through it to the American Company, as the owner of 99% of its stock) derived from the sale to the Chicago Company of apparatus recommended by the American Company as part of its service of business management.

The American Company, as the owner of 99% of the stock, received in 1923 not only the earnings which the rates prescribed by the Order of August 16, 1923, produced, but, in addition thereto, the additional advantages of pecuniary value which we have shown existed but can not be determined. The American Company is not the ordinary investor who participates in the earnings of the company in which he invests only through the dividends received and through the enhancement in value of his holdings through

the accumulation of earnings in the treasury of such company. The American Company not only receives all that such ordinary investor receives, but also the benefit of the *use of the property and personnel* of the Chicago Company *free of charge* for its own benefit and at the expense of the earnings of such company. By such free use it has been able to make a large share of its own gross earnings constitute net earnings. Similarly, through the use of its stock ownership, it has administered the affairs of the Chicago Company for its own purposes without the legal restraints incident to the latter's separate corporate legal existence. By so doing the American Company has been able to offer as its own a long distance service which otherwise would have been impossible, and which presumably is profitable, and has provided a steady customer for its manufactured products on a monopoly basis, and free from competition (*Chesapeake & Potomac Tel. Co. of Virginia* v. *Commonwealth of Virginia,* 147 Va. 43, 80, 82, 136 S. E. 575).

To compare the status of the American Company as an investor with that of the public seeking to invest, is to distort the facts.

The Commission had before it the picture of this relationship and established a rate which, under all the circumstances and upon all the facts before it, it considered reasonable. The Statutory Court does not pass upon the reasonableness of these rates as such. It must consider only the complaint of the Chicago Company that the established and presumptively reasonable rates are below the minimum to which it is constitutionally entitled. Part of its proof is to show the revenues and expenses and capital dedicated to the local exchange services covered by the rates complained of. But this the Chicago Company can not do on the present record, as it failed to show the amount by which its net earnings would have been increased had the Amer-

ican Company acted in relation to it as the ordinary investor does. Nor can it so do until it shows how much the value is to the American Company of occupying the unusual investor relationship which permits it to use the property and personnel of the Chicago Company for its own purposes free of charge and as it determines.

As already noted, the cash net earnings for 1923 found by the Statutory Court available for return of 5.39% exceeded the cash net earnings which the Chicago Company recorded and used as a basis for financing. The holders of the credit obligations apparently were attracted on that showing (*supra,* 348). The American Company itself was attracted, whether because of the use it made of the Chicago Company for its own operations or for investment. Who can say that the latter basis of attraction is constitutionally inadequate without measuring the value of the former?

In *Chesapeake & Potomac Tel. Co. of Virginia* v. *Commonwealth of Virginia*, 147 Va. 43, the Supreme Court of Virginia refused to hold that an estimated return of 6.50% under rates prescribed by the Virginia Corporation Commission was inadequate, in view of the relationship between the Bell licensees before it and the American Company (*Idem,* 85). In *Chesapeake & Potomac Tel. Co.* v. *Whitman*, 3 Fed. (2d) 938, the Statutory Court refused to hold that 6% was not a fair return in view of the Bell System relationship.

For the following reasons a return of 5.39% in the instant case should not be held confiscatory in view of the Bell System relationship:

1. In neither of these two cases does it appear that the Bell licensee was entitled to a "reasonable and suitable division of the tolls and profits" of the long distance business transacted in its territory as was the Chicago Company (*supra,* 41).

2. In neither of these cases was the amount of long distance business as large as in the instant case, nor was the strategic importance of the Bell licensee in such service as great as that of the Chicago Company.

3. In neither of these cases does it appear that the Bell licensee rendered special financial services of character similar to those rendered by the Chicago Company; and

4. In neither of these cases does it appear that the Bell licensee could and did finance itself on a per cent return which was even less than the cash return complained of.

The Statutory Court erred in holding that the cash net income found available for return in 1923 was constitutionally inadequate.

DISCUSSION AS TO TEST NUMBERED IV.

IV.

THE NET EARNINGS AVAILABLE FOR RETURNS IN 1923, AS FOUND BY THE STATUTORY COURT, ARE MORE THAN THE MINIMUM WHICH THE CHICAGO COMPANY IS CONSTITUTIONALLY ENTITLED TO RECEIVE THEREFROM, WHEN TESTED ON A COMPARABLE BASIS BY THE YARDSTICK PROPERLY APPLICABLE TO DETERMINE THE REQUIRED MINIMUM NET EARNINGS FROM THE OPERATIONS OF THE BELL LICENSEE COMPANIES.

DISCUSSION AS TO CONTENTION NUMBERED I.

I.

IT FAILED TO TAKE INTO ACCOUNT AND TO GIVE EFFECT TO THE FACT THAT THE CHICAGO COMPANY, AS PART OF THE BELL SYSTEM, DIFFERS SO WIDELY IN FORM OF ORGANIZATION AND IN RELATION TO THE PUBLIC AND THE INVESTORS FROM THE ENTERPRISES CONSIDERED IN THE CASES CITED BY THE STATUTORY COURT THAT THEIR EXPERIENCE IS RENDERED WHOLLY INAPPLICABLE TO IT.

A.

The actual experience of the Chicago Company for five years after the effective date of the Order complained of demonstrates the futility of applying to it the experience of independent enterprises.

On the basis of the Statutory Court's valuation the yield for the period 1923 to 1925 from the Chicago operations

under the rates established by the Order of December 20, 1920, averaged 4.69% and for the period 1923 to 1928, 4.33%*. On the same basis of valuation (adjusted only to increase going value and working capital in the ratio of total company physical plant to Chicago plant) the average per cent return from the entire Chicago Company operations for 1923-1925, was 4.76% (R. I, 196, 197).

All such returns are admittedly inadequate if tested by the yardstick applicable to independent enterprises. Yet as we have already seen, the Chicago Company has been able not only to finance its needs but its securities have maintained a most favorable position throughout such period in comparison with those of other high grade utilities. It follows, therefore, that the actual experience of the Chicago Company for a period of five years since the effective date of the Order complained of is wholly at variance with the expected experience of a utility claiming that its rates are constitutionally inadequate, and leads to one of two conclusions: either the yardstick applied in situations to which the instant situation might be expected to be similar is rendered illusory by the test of actual experience, or the instant situation so differs in essentials from such others as to render their experience wholly inapplicable to it.

*The Chicago Company's investment in physical property at the close of each year (R. IV, 1193) was increased 37% to give effect to the level of reproduction cost as reflected in the rate base value as of June 30, 1923, as found by the Statutory Court (*supra*, 301). This was then reduced 10% for depreciation, as found by the Statutory Court, to which adjusted plant figures were added to the Statutory Court's finding of going value and working capital (R. I, 197). The rate base so computed was related to the earnings available for return (R. IV, 1193).

B.

The Chicago Company, as part of the Bell System, admittedly occupies a unique position in the form of its organization and in relation to the public and investors.

The American Company, as the manager of the Chicago Company and responsible head of the Bell System, has stated that:

> "The Bell Telephone System occupies a unique position, and one not generally understood, because it differs so widely in form of organization and in relation to the public and the investors from other enterprises to which it might be expected to be similar. In the annual reports which have grown up to be vehicles of information to the public as well as to the stockholders, we have attempted to set forth the reasons why the structure of the System is what it is, what the relations of the parts are to each other and all the other facts which should be available to present and prospective investors in the securities of the System." (R. VII, 2619, p. 15; R. VII, 2678).

Elements of uniqueness of the position of the Chicago Company.

(a) THE AMERICAN COMPANY HAS DESTROYED THE POSSIBILITY OF OPERATING THE CHICAGO COMPANY AS AN INDEPENDENT ENTERPRISE.

There are at least 10 reasons for this destruction:

(1) All of the departments of the Chicago Company other than its operating organization have been transferred to the American Company to be operated under the latter's exclusive control (*supra*, 259);

(2) Its operating organization functions as a division of the Bell System on the basis of conforming its operations to the standard of the System as a whole and not to that of the local situation alone. Such operations substitute for the individual initiative of

local operating genius, the superimposed standard of the American Company suited to operation of the Chicago Company as a unit of the Bell System and not as an independent enterprise (*supra*, 260);

(3) The policy of standardization of equipment has placed the Chicago Company's plant completely within the control of the Western Electric, the only manufacturer able to supply replacements or additions (R. III, 1120). The relationship of the Western Electric with the Chicago Company is contingent on the relationship of the latter with the American Company by contract, by stock ownership, and by management control (R. VI, 2388). The inability to replace or to extend the local property without the continuation of the relations with the American Company destroys the merchantability of the property for any purpose not satisfactory to the American Company;

(4) The policy of passing the burden of supporting the unremunerative parts of the Bell System on to the System as a whole (*supra*, 265) increases the cost of operation to the Chicago Company by an amount determined solely by the American Company;

(5) The financial policy of the American Company of pooling the resources of all licensee companies as a basis for financing any licensee company (*supra*, 265) uses the superior credit of the Chicago Company for the benefit of the other companies controlled by the American Company, and takes the control thereover away from the Chicago Company itself;

(6) The policy of using the capital of one company to finance another company removes the opportunity to conserve the financial credit of the Chicago Company for its own benefit;

(7) The fact that the policy of the Chicago Company in all legal matters is determined by the legal department of the American Company on the basis of its being consistent with the policies of the balance of the System and not for the sole benefit of the Chicago Company destroys the advantages held by it as a result of its strategic position and the favorable contracts made prior to the date when the program of unification commenced.

(8) The pooling of the management of the Chicago Company with that of other licensee companies of varying strength and having different contractual relations

(*infra*, 159) destroys the possibility of determining the costs of such management to the Chicago Company;

(9) The fact that the Chicago Company admittedly is operated by the American Company as part of the Bell System without limitation of the former's property ownership or of any legal restraint in the administration of its affairs incident to its separate and distinct corporate existence (*supra*, 368) destroys all possibility of its independent management and operation as an independent enterprise.

(10) Since 1919 the merchantability of property of the Chicago Company as an operating entity has been made dependent on the will of the American Company. The 1919 Memorandum provides for forfeiture by the Chicago Company of its contract through transfer (voluntary or involuntary). As its contract defines and provides for its relationship to the Bell System, the danger of its being without management destroys the value that would result to the Chicago Company as an independent enterprise through the power to mortgage, sell, reorganize or refinance the business, if such procedure were found necessary or convenient. This was illustrated in 1923 by the necessity of mortgaging the rights of the Chicago Company under the 1919 Memorandum as part of the security under the $50,000,000 bond issue. The consent of the American Company was required (R. IV, 1567).

(b) THE AMERICAN COMPANY HAS DESTROYED THE POSSIBILITY OF DETERMINING THE ACTUAL COSTS AND CHARGES OF THE SERVICES OF THE CHICAGO COMPANY FROM THE LATTER'S RECORDS ALONE.

The American Company, as manager of the public utility functions of the Chicago Company, acknowledges that the affairs of the Chicago Company are so commingled with those of the other licensee companies of the Bell System, that it is impossible to keep the accounts of each separately; also that to understand or correctly determine the actual costs and charges of the telephone service one must consider their combined revenues, expenses and balance sheets (R. VII, 2543 (4); 2569 (7)). "This explanation," the

American Company says, "is made so that there may be no excuse for misstating the costs and profits of the telephone service" (R. VII, 2543 (4)). The American Company has repeatedly made the same explanation before and after its acknowledged assumption of managerial control of the Chicago Company, the knowledge of which explanation has come to, and has not been disputed by, the employees and officials of the Chicago Company who have become stockholders of the American Company. The comptroller of the American Company testified that it is impossible to separate for each company the costs of the central administration (R. V, 1814). His later qualification that he could allocate these costs by a division on the gross costs upon the basis of relative size of operations of the separate companies (R. V, 1817) is unsatisfactory as the variation in the kind of service required by the separate Bell licensee companies and in the nature of the obligation among them to pay therefor, makes an allocation on the basis of prorating gross costs unfair to the Chicago Company (*supra,* 243). Concrete evidence of such unfairness is revealed by the relative distribution of the payments made by the five licensee companies composing the Central group (*supra,* 189). Similarly the records of the Chicago Company alone do not disclose the cost to it of rendering services to the American Company in its long distance service or of the other services already noted which are rendered to the latter and to other licensee companies of the Bell System, for all of which services no charges have been made by the Chicago Company, but the expenses of which are included in the local operating charges (*supra,* 35, 223).

The Statutory Court in finding the revenues and expenses of the Chicago service from the records of the Chicago Company alone must have acted either on the basis that the admissions of the American Company, as manager, are false, or on the basis that the court in its judicial capacity

should ignore that which the American Company desired it, as part of the public, to know.

(c) PART OF THE EARNINGS AVAILABLE FOR RETURN ON THE INVESTMENT OF THE CHICAGO COMPANY IS HELD IN THE TREASURY OF THE AMERICAN COMPANY, THE RECORD OF WHICH AND THE USE WHEREOF ARE NOT AVAILABLE TO THE CHICAGO COMPANY AS AN INDEPENDENT ENTERPRISE.

As already noted, the American Company has operated the licensee companies, including the Chicago Company, without limitation of property ownership or of the legal restraints incident to the administration of their affairs as separate and distinct corporate entities (*supra,* 267). Instead of making a strict accounting to each licensee company of the results of its operations, the American Company makes available the profits in its treasury for the benefit of the Bell System as a whole:

> "In the Bell Telephone System taken as a whole more than in any other utility, profits are conserved within the System for the benefit of *the public and the stockholders.* There are intercompany profits on use of patents, on expert engineering advice, etc., and on manufacturers, but either through the 4½% payment or the dividends of the manufacturing company, these profits come to the treasury of the American Telephone & Telegraph Company, the financing company of the System. Except for the dividends on the small amount of stock of the associated companies in the hands of the public all profits of the Bell Telephone System ultimately come to the treasury of the American Telephone & Telegraph Company." (R. VII, 2583 (21)). "It retains for the ultimate benefit of the System and the public what the System itself has produced." (R. VII, 2602 (7)). (Italics ours.)

But it is obvious that neither the record of such profits, nor the amount thereof to which the Chicago Company, as a part of the System, is entitled, nor the use thereof, are available to it as an independent enterprise. It therefore

cannot make use of such added earnings in attracting capital or in maintaining the stability of its securities as an independent enterprise.

(d) THE AMERICAN COMPANY HAS DESTROYED THE GOING VALUE OF THE CHICAGO COMPANY AS AN INDEPENDENT ENTERPRISE.

Going value was defined on behalf of the Chicago Company as

> "an additional value that any well conducted, well managed property, that is earning money, has as an operating entity above the bare bones cost of such a property, which just involves the physical costs, and nothing else." (R. II, 709).

From the conclusions already reached that the American Company has destroyed the possibility of operating the Chicago Company as an independent enterprise (*supra,* 359), and has destroyed the possibility of determining the actual costs and charges of the services of the Chicago Company from the latter's record alone (*supra,* 361), and that part of the earnings of the Chicago Company go into the treasury of the American Company, the record of the amount of which and the use whereof are not available to the Chicago Company as an independent enterprise (*supra,* 362), it necessarily follows that the Going Value of the business of the Chicago Company as a separate entity has been destroyed, or at least has been made dependent on the will of the American Company. It is inconceivable that a purchaser would pay for property of the Chicago Company any more than its salvage value, if the business to be conducted thereafter by it were to be on the basis of a separate and distinct operating entity not managed by the American Company and not having the right to continue the contractual relations with the American Company. All departments other than its operating organization would be missing (*supra,* 210); the employes of the

operating organization would bear allegiance to the Bell System and not to the purchaser (*supra,* 66); new standards of efficiency based upon local experience would be required to replace the standards of the Bell System now in use (*supra,* 260); replacements of equipment from the Western Electric would be on an entirely different basis than that now in force (*supra,* 278); in short, all the factors necessary to the existence of Going Value would either be destroyed by the sale or be replaced by the purchase of the Chicago Company. The Going Value of the Chicago Company as an independent enterprise has been completely destroyed (*Chesapeake & Potomac Tel. Co. of Virginia* v. *Commonwealth of Virginia,* 147 Va. 43, 136 S. E. 575).

DISCUSSION AS TO CONTENTION NUMBERED II.

II.

THE NET EARNINGS AVAILABLE FOR RETURNS IN 1923, AS FOUND BY THE STATUTORY COURT, ARE LEGALLY ADEQUATE, AS TESTED BY THE YARDSTICK APPLICABLE TO AND IN FACT USED IN THE BELL SYSTEM IN 1923 TO DETERMINE THE ADEQUATE RETURNS TO EACH LICENSEE COMPANY FROM ITS OWN OPERATIONS.

A.

The American Company has made itself the financing company to provide the permanent capital for the licensee companies of the Bell System.

As already noted, the American Company, to avoid any question of "conflicting interests" because of its operation of the Bell System without limitation of property ownership, acquired in 1911 large independent minority stock holdings in the different licensee companies, including the Chicago Company, and thereafter constantly added thereto so that on June 30, 1923, it owned directly or indirectly practically all of the common stock of the Bell licensee companies, including 98.5% of the stock of the Chicago Company (R. VI, 2280-2), which latter percentage was further increased thereafter (R. VI, 1982). Since February 1, 1919, the American Company has made its consent necessary before the Chicago Company may finance directly with the public through the sale of credit securities (*supra*, 264). Since 1911 the financing of permanent capital by the Chicago Company has been either by sale of its stock to its stockholders, which in effect means to the American Company, or by the sale of its credit obligations to the public

after the American Company has consented thereto and made available to the holders of such securities the benefits of the position of the Chicago Company as an operating division of the Bell System (R. IV, 1567).

B.

The American Company, as the financing company, has provided a cooperative plan for the financing of the licensee companies.

The American Company has established and uses a cooperative plan of financing the needs of the Bell System. This plan involves the combination and use for the benefit of the System as a whole of six contributions which it and each of the Bell licensee companies separately makes to the operation of the System as a single enterprise.

SIX CONTRIBUTIONS BY LICENSEE COMPANIES.

1. The licensee companies pay a yearly uniform assessment determined by the American Company to maintain outside their respective territories its operations as the headquarters department functioning for the Bell System as a whole (4½% payment as discussed *supra,* 142).

2. The licensee companies perform within their own territories without charge such uniform services for the headquarters department as it may require, such as selling stock, advertising the Bell System as a whole, and making available personnel to other licensee companies, as required for their efficient operation (*supra,* 147).

3. The licensee companies perform within their own territories on a uniform basis such uniform services through the use of their exchange plant and the operating personnel in connection therewith for the interconnection between them by long distance lines, as the headquarters department may require (*supra,* 27).

4. The licensee companies pay to the headquarters department for the use of permanent capital or of temporary funds supplied by it to them, uniform cash dividend (R. V, 1813) or interest rates (R. V, 1809-10).

5. The licensee companies pay uniform prices for all purchases made from the manufacturing department of the Bell System represented by the Western Electric (R. VI, 2070).

6. Each licensee company, after absorbing the costs and expenses of performing the above services in its own territory and of the assessment to the headquarters department just described, is expected to maintain net earnings from its own operations to yield a per cent return on its investment not less than the average per cent return on a comparable basis on the investment of the licensee companies as a whole as used or found necessary to attract capital and to maintain the stability of the securities of the Bell System (R. VII, 2658 (5); 2605 (12)).

SIX CONTRIBUTIONS BY THE AMERICAN COMPANY.

1. The physical assets of the American Company and the physical assets of all of the licensee companies are pooled to form the rate base upon which the adequate per cent amount of return is calculated in order to attract the investors of the American Company, who are considered the investors of the Bell System (R. VII, 2604 (11); 2616 (6-7); 2633 (13)). If the American Company considered itself (as the Chicago Company insists that it is) an operating company of the long distance service and a holding company of capital and credit securities in the licensee companies, the American Company should consider as a rate base for the purpose just mentioned, the physical assets of the American Company and the book cost or value of such capital and credit securities and not the assets of the American Company plus the book cost or value of the physical assets of such licensee companies.

2. All of the earnings in the treasury of the American Company over and above the actual expenses of the Central Administration, plus all of the net earnings of the Western Electric, plus all of the earnings of the long lines department, are pooled with the net earnings of the licensee companies from their own operations, for the financing of all of the parts of the Bell System (R. VII, 2681 (6-7); 2584 (21-22)).

3. The cash dividends paid to the American Company by the licensee companies are pooled with the net earnings of its own treasury from the long distance service and from the 4½% payments remaining above the expenses of the Central Administration, and with the cash dividends from the Western Electric, to form the fund to pay the cash return to its own investors as the investors of the Bell System (R. VII, 2681 (6-7)).

4. The surplus in the treasury of each licensee company is pooled with the surplus of the net profits of the Central Administration, the surplus of the net profits from the Long Lines Department, to form the combined surplus to safeguard the continuity of dividends to the investors of the Bell System from the American Company.

5. All of the funds derived by the American Company from its investors are used to finance every part of the Bell System (R. VII, 2638 (40); 2655 (40)).

6. The American Company, by consenting to the pledge by a licensee company of the latter's rights under its contract defining its relationship to the Bell System, makes available to the holders of the credit securities issued by each such licensee company, the same benefits of the co-operative financing plan as are available to the stock investors of the American Company as investors of the Bell System. The inter-relation between the market position of these stock investments and the cost of financing and posi-

tion of the credit obligations issued by the licensee companies is one factor considered by the American Company itself in determining the necessary cash dividends required to attract its investors and to maintain the market position of their investments (R. VII, 2616 (6, 7)).

C.

The required net earnings from the operations of each licensee company are admittedly less than the minimum per cent return necessary to attract capital or to maintain the stability of its securities under the cooperative plan of financing the licensee companies of the Bell System.

From the above analysis it is obvious that the net earnings from the operations of the Chicago Company need not be and cannot be as large as if it were operating as an independent enterprise. In the Bell System the net earnings available to attract the capital investors of the licensee companies—that is, the stockholders of the American Company—are to be found in two treasuries, *i. e.*, that of the licensee company, and that of the American Company. An examination of the Annual Reports of the American Company beginning with 1914 reveals that the net earnings left in the treasury of the licensee companies of the Bell System have been far below the combined net earnings available to the investors of the Bell System and below the minimum net earnings which in the case of an independent enterprise would be required to avoid confiscation (R. VII, 2670 (8)). Thus we find the American Company stating to the investors of the Bell System that the ratio of net earnings remaining in the treasury of the licensee companies to the book cost of plant in such companies averaged 5.2% in 1921 (R. VII, 2618 (13)), 5.6% in 1922 (R. VII, 2633 (12)) and 5.4% in 1923 (R. VII, 2647 (12))—a per

cent return admittedly far below the minimum considered legally adequate for independent enterprises when considered on the basis of present value. Yet, in each of such years, dividends were earned plus a margin; in each of such years, the American Company earned, by combining the Bell System earnings in its own treasury with the Bell System earnings in the treasury of the separate companies, over 12% on its stock held by the public (R. VII, 2594 (46); 2618 (12); 2633 (12); 2647 (12-13)), which latter earnings per share were larger than the per share earnings for any year since 1900, and were sufficient to warrant an increase in 1921 in cash dividends from 8% to 9%—a rate maintained ever since (R. VII, 2617 (6-7)).

Nor has the American Company experienced any difficulty either in attracting capital or in maintaining the stability of its securities in comparison with those of other companies with whom it must compete for capital. Indeed, in 1923 with the average showing by the separate licensee companies less favorable than that of the Chicago Company, as already noted, the combined showing of the Bell System under the co-operative plan just described was such as to cause the American Company to admit:

> "There are few, if any, important stocks which have greater stability as to earnings than the stock of your company and its market stability may be compared with high grade bonds of railroads and industrial companies rather than with stocks." (R. VII, 2646, (12)).

Nor have the credit obligations of the licensee companies issued to and held by the public suffered as a result of the showing from their own operations in comparison with that of other companies with which the Bell System competed for capital. The credit obligations of the two licensee companies which issued such securities in 1923 were sold in the open market to yield to the holder the first and third lowest per cent of return, respectively, of any of

the 36 issues of public utility securities of the same class sold in the open market that year (R. IV, 1276).

Nor has the showing of the Chicago Company (which is more favorable than the average showing of the licensee companies, but admittedly inadequate if judged by the yardstick applied to independent enterprises, R. I, ~~Opinion~~), impaired the stability of its securities in comparison with those of such other enterprises (R. VI, 2160).

D.

There is no possible basis of comparison between the required minimum net earnings from the operations of licensee companies and those of independent enterprises to which they might be expected to be similar.

The operations of each licensee company must absorb the cost to it of rendering within its own territory without charge services for the headquarters department of the Bell System and for the interconnecting long distance service and of paying the assessment for the operations of the former department outside its own territory, which assessment bears no relation to the cost of or benefit from such operations to any particular licensee company; the operations of independent enterprises outside the Bell System have no such costs and charges to absorb. On the other hand, each licensee company, for the purpose of attracting capital and of maintaining the stability of its securities by and through the American Company, augments its own earnings by the contributions of the latter company to its own net earnings. Such contributions are neither available to the licensee company for those purposes, if its situation is considered separately and apart from that of the Bell System as a whole, nor does an independent enterprise outside of the Bell System augment its own earnings in any

such manner. Any comparison, therefore, of the minimum net earnings of a licensee company from its own operations with those of independent enterprises outside the Bell System, which makes no allowance for the special factors affecting the earnings of the former, is illusory. As there is no measurable standard by which the effect of such special factors can be gauged, there is necessarily no comparable basis of comparison between the two classes of enterprises.

E.

There is no possible basis on which the yardstick applied in cases of independent enterprises to determine the minimum net return to which a utility is constitutionally entitled, can be applied to determine the minimum net earnings from its own operations to which a Bell Licensee Company is constitutionally entitled.

The minimum per cent return of net earnings to investment required in cases of independent enterprises bears no relation to the total net earnings of the enterprise available to attract capital and to maintain the stability of the securities of the utility under investigation; the net earnings for the operations of the licensee companies are not the total net earnings available for the same purpose, but are only a portion thereof. It is therefore obvious that the application to the net earnings of each licensee company from its own operations only, of the same per cent of return applicable to independent enterprises outside the Bell System, is arbitrary and illusory. This difference in the situations of the two classes of enterprise accounts for the fatal variance, already disclosed, between the five-year experience of the Chicago Company, and the expected experience of a utility whose rates have been found constitutionally inadequate (*supra*, 348).

F.

To determine the minimum return to which the Chicago Company is constitutionally entitled in relation to the net earnings from its own operations in Chicago, the only possible yardstick applicable thereto is the average per cent return, on a comparable basis, on the investment of the Bell licensee companies as a whole, as used in fact or as found necessary to finance their needs and to maintain the stability of their securities.

From the analysis of the co-operative plan of financing of the licensee companies already described, it is apparent that when each licensee company makes the six uniform contributions required by it to be made, it has complied with all possible requirements necessary on its part to enable the American Company as the financing department to attract capital for it and to maintain the stability of its securities. The minimum average net earnings from the operations of the licensee companies as a whole must be such that when pooled with the contributions made by the American Company itself, they will be adequate to attract capital and to maintain the stability of the securities of the Bell System (R. VII, 2618, (12)).

The constitutional adequacy of the rates of any particular licensee company should therefore be determined by viewing the relation of the net earnings from its own operations to the average required minimum net earnings, on a comparable basis, of all licensee companies bearing the same relation to the American Company as the licensee company under investigation, and predicated upon (a) its and their operations having absorbed the costs of services and payments required to be made by it and by them as part of its and their contributions to the operation of the Bell System as a unified single operating entity, and (b) the suffici-

ency of the average minimum net earnings from the operations of all the licensee companies when pooled with the contributions by the American Company to such operations, to provide the minimum net earnings which the Bell System as a single operating entity requires to attract capital for the licensee companies and to maintain the stability of their securities during the period under investigation. In the absence of a showing that the average net earnings from the operations of licensee companies are inadequate no issue of confiscation can arise as to the net earnings from the operations of any single licensee so long as such licensee's showing is as good as or is better than such average.

There are at least ten reasons why this yardstick should be adopted in the instant case: (1) It and it alone bears relation to the actualities of the situation. It is the yardstick which the American Company itself currently applies in its operation of the Bell System and the data for the use of which it has readily available and can and does make accessible to the licensee companies, to the investors of the Bell System, and to the public generally. (2) It provides a definite measurable standard to prevent imposition on any particular community because of the operations of the telephone property and of the local organization applicable thereto by the American Company without limitation of property ownership or of legal restraints incident to the administration of the affairs of the owning company as a separate and distinct corporate entity, so long as such operation is uniformly applied throughout the Bell System in similar disregard of the same limitations. (3) Although it provides a practical method by which commissions and courts in any section of the country can protect the local community served against any bad effect of the operation of the Bell System in disregard of the two limitations just mentioned, at the same time the application of this method will not disrupt such operations nor impair the investment

of the large amount of capital invested therein in reliance on such operations so conducted. (4) It provides a practical method by which, in the absence of the power of regulation in any particular case over the American Company itself, commissions or courts in any section of the country can prevent the operations of the local utility under investigation from being used to provide more than its just share towards a single fair return on the investment located within and without the jurisdiction of the reviewing authority necessary to render the service covered by the particular rates under investigation. (5) It makes possible the test of the legal adequacy of the rates of each licensee company by the simple method of comparison of its showing with that of the other licensee companies making use of any comparable basis such as book cost of plant—a basis in fact urged by the American Company itself. Consequently, each licensee company (and through it the public served) is saved the expense, delay and uncertainties incident to the valuation of property and prognostication of rate of return necessary under the customary tests now in force. (*State of Missouri, ex rel., Southwestern Bell Tel. Co.* v. *Public Service Comm of Missouri,* 262 U. S. 276, 308). It is only when it affirmatively appears that (a) the net earnings from the operations of a particular licensee company are less on a comparable basis than the average net earnings of all licensee companies, or that (b) such average net earnings are not sufficient when pooled with the net earnings of the American Company to provide the required minimum return to attract capital and maintain the stability of the securities of the Bell System—only then do the questions of value of property in the Bell System or of rate of return become important. In the instant case, the net earnings of the Chicago Exchange for 1923 even after giving effect to the Order of August 16, 1923, are on their face more favorable on any comparable basis than the aver-

age net earnings of the licensee companies for the same year as disclosed by the American Company itself (*infra*, 379). The Statutory proceedings should therefore never have been brought, or, if brought, should have been summarily disposed of by the Statutory Court.* (6) It eliminates the necessity of a strict accounting in each case between the licensee company under investigation and the American Company arising from the latter's operation of the former's property and organization in the manner already described, which accounting would be otherwise necessary as a condition precedent to the granting of relief to such licensee company or to the proper review by any court of the action of any commission affecting the rates of such licensee company. (*People* v. *Michigan Bell Tel. Co.*, 246 Mich. 198, 224 N. W. 438. (7) It assures to each licensee company and through it to the community served, the full benefit of the contributions by such licensee company resulting in the favorable position of the securities of the Bell System in comparison with those of other enterprises with which the System must compete for capital. Each licensee company is as much responsible as is every other licensee company and as is the American Company for the unusual stability of the telephone business of the Bell System (R. VII, 2593), for the unusual stability of its earnings, and for the unusual market stability of its securities—all of which factors make the stock of the American Company, as the financing company of the Bell System, admittedly comparable to high grade bonds of railroad and industrial companies rather than to stock (R. VII, 2646, (12)). In no other way is there tangibly reflected what the American Company itself admits that the licensee companies enjoy in fact: "The System, although made up

*Nor is the application of such yardstick to the net earnings of Bell licensee companies in anywise an arbitrary class discrimination against non-licensee telephone companies. They operate as independent enterprises even when they have connecting agreements with Bell licensee companies, while the latter, for the application herein urged, are not considered as independent enterprises at all.

of many separate corporate entities, operates as one organization and enjoys the benefits of one organization" (R. VII, 2579, (7); 2681, (6-7)) (8). It eliminates any question of discrimination among licensee companies through the charge by the American Company to the borrowing licensee companies of a lower rate of interest on loans than the open market rates or than the rates required of the American Company to procure funds therefor or for itself during the period of such loans (*supra*, 189). Similarly, it eliminates any question of discrimination among licensee companies, through the method of financing the needs of one licensee company by capital investments yielding 8% dividends and of financing other licensee companies partially by capital investments and partially by low interest-bearing credit securities (*supra*, 188). Similarly it eliminates any question of discrimination against the communities served by the Bell System as against non-licensees by reason of the charge by the former to operating expense of the royalties paid on Western Electric apparatus (*supra*, 281). This elimination is made possible by the yardstick herein urged, which involves a comparison of the relative net earnings of licensee companies available for interest and dividends and not the relative net earnings after deducting interest and dividends. (9) It makes possible the absorption as part of the expenses to be covered by the rates charged by the Chicago Company of the entire cost of the services rendered by it in its own territory for the Bell System as a whole and of the assessment made to the headquarters organization to cover the common services, without raising any question of the fairness of such arrangement either because of the basis of charge made or the amount of total expense absorbed (*supra*, 142). (10) It substitutes a positive, uniform, measurable standard based upon scien-

tific measurement from easily available, accumulated data of the experience of the Bell System,—for the purely negative, variable standard based upon *a priori* reasoning, now applied in various sections of the country in an attempt to reflect as part of the proper rate return the effect of part or of all of the differences between the position of the licensee companies, as part of the Bell System, and independent enterprises with which they are compared. (*Chesapeake & Potomac Tel. Co. of Virginia* v. *Commonwealth of Virginia*, 147 Va. 43, 136 S. E. 575; *Re New York Telephone Co.*, P. U. R. 1923 B. 545, 572 (New York)).*

G.

The net earnings available for return in 1923 are more than the minimum which the Chicago Company is constitutionally entitled to receive therefrom, when tested, on a comparable basis, by the yardstick properly applicable to determine the required minimum net earnings from the operations of the Bell licensee companies.

Neither the Chicago Company in the presentation of its case nor the Statutory Court in making its decision applied the yardstick applicable to the Bell System as herein urged. But the Statutory Court used in its calculations the net earnings of $6,740,000 available in 1923 for return under the rates complained of after adding back to such earnings that portion of the 4½% payment made to the American Company, which was in excess by $360,000 of the amount which the Commission held was properly charge-

* Three of the cases cited by the Statutory Court in support of its position involve Bell licensee companies (*Southwestern Bell Telephone Co.* v. *City of Ft. Smith*, 294 Fed. 102; *Southern Bell Tel. Co.* v. *Railroad Company of So. Carolina*, 5 Fed. (2d) 77; *New York Tel. Co.* v. *Prendergast*, 300 Fed. 822). In the first two cases the decision treats the company before the reviewing authority as in all respects similar to independent enterprises to which it is compared, and in the third case the decision gives effect to some differences between the company before the reviewing authority and independent enterprises.

able as an operating expense (R. I, 197). By charging to operating expense this sum of $360,000 the resulting $6,380,000 will represent the net earnings from the operations of the Chicago Exchange after they have absorbed all of the costs of service and all of the payments required to be made by the Chicago Exchange as its contribution to the operation of the Bell System as a unit under the cooperative plan of financing already described (*supra*, 367). The record also shows that the net earnings from the operations of all Bell licensee companies for the same year after absorbing the costs of services and of payments required to be made by them as their respective contributions to the operation of the Bell System as a unit, averaged 5.4% of the book cost of property of such licensee companies (*supra*, 370). The per cent of return of net earnings to book cost of property of the licensee companies from their operations for the three-year period from 1921 to 1923 was likewise 5.4% (*supra*, 370). But the adjusted net earnings of $6,380,000 derived from the operations of the Chicago Exchange in 1923 was 6.2% of the book cost of its property as found by the Statutory Court (R. I, 197). There was no showing to the effect that the 5.4% average net earnings were not adequate contributions by each licensee company to attract capital to it and to maintain the stability of its securities. On the contrary, their adequacy affirmatively appears from the admissions of the American Company (*supra*, 371) and from the market position of the securities of the Bell System in 1923 (*supra*, 371). We must, therefore, conclude that the net earnings from the operations of the Chicago Exchange in 1923, which exceeded, on a comparable basis, the average net earnings of all the licensee companies, are neither *in*adequate nor *un*reasonable.

The test just made of the net earnings of the Chicago Exchange is most unfavorable to the telephone *users in*

Chicago because it is predicated upon the Chicago Exchange rendering on a uniform basis of the same service involved in the use in the long distance service of its local exchange plant and of the operating personnel in connection therewith as is rendered by the other licensee companies in the long distance service. But such uniformity involves a surrender, without consideration, of the tangible advantage which the Chicago Company has under Section 10 of the Original License Contract of 1881, by which it is assured reimbursement of at least all costs and expenses of such use of the exchange plant and personnel (*supra*, 41). This right it alone of the Bell licensee companies had, and in 1923 surrendered. The other licensee companies continued to receive in 1923, as before, the same compensation for the use of their necessary exchange facilities excepting the local exchange plant and the operating personnel in connection therewith as they could demand for the use of these necessary exchange facilities including such plant and personnel (*supra*, 90). The showing of the Chicago Company is determined, therefore, after its absorption of the additional cost of making use of the local exchange plant and the operating personnel in connection therewith, for the use for which it had a right to be compensated, while this factor is not taken into account in the showing of the other licensee companies to which it has been compared. How much that cost is, the record does not disclose and the Chicago Company has refused to determine. From the long discussion under the topic "Long Distance Service," (*supra*, 27), we maintain that the sacrifice is very substantial.

As the showing of the Chicago Exchange is more favorable than the average showing of the other licensee companies from their operations*, it is not even necessary to

* The showing of the Chicago Company as a whole for 1923 was also more favorable than the average showing of the licensee companies (*supra*, 348).

consider the question of whether such average showing, plus the net earnings in the treasury of the American Company and available for the System as a whole, are together more than the required minimum to attract capital to the licensee companies and to maintain the stability of their securities.

The Statutory Court erred in not dismissing the bill of complaint of the Chicago Company, in not dissolving the temporary injunction, and in not ordering a refund of all sums collected by the Chicago Company in excess of the rates prescribed by the Order of August 16, 1923.

Respectfully submitted,

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